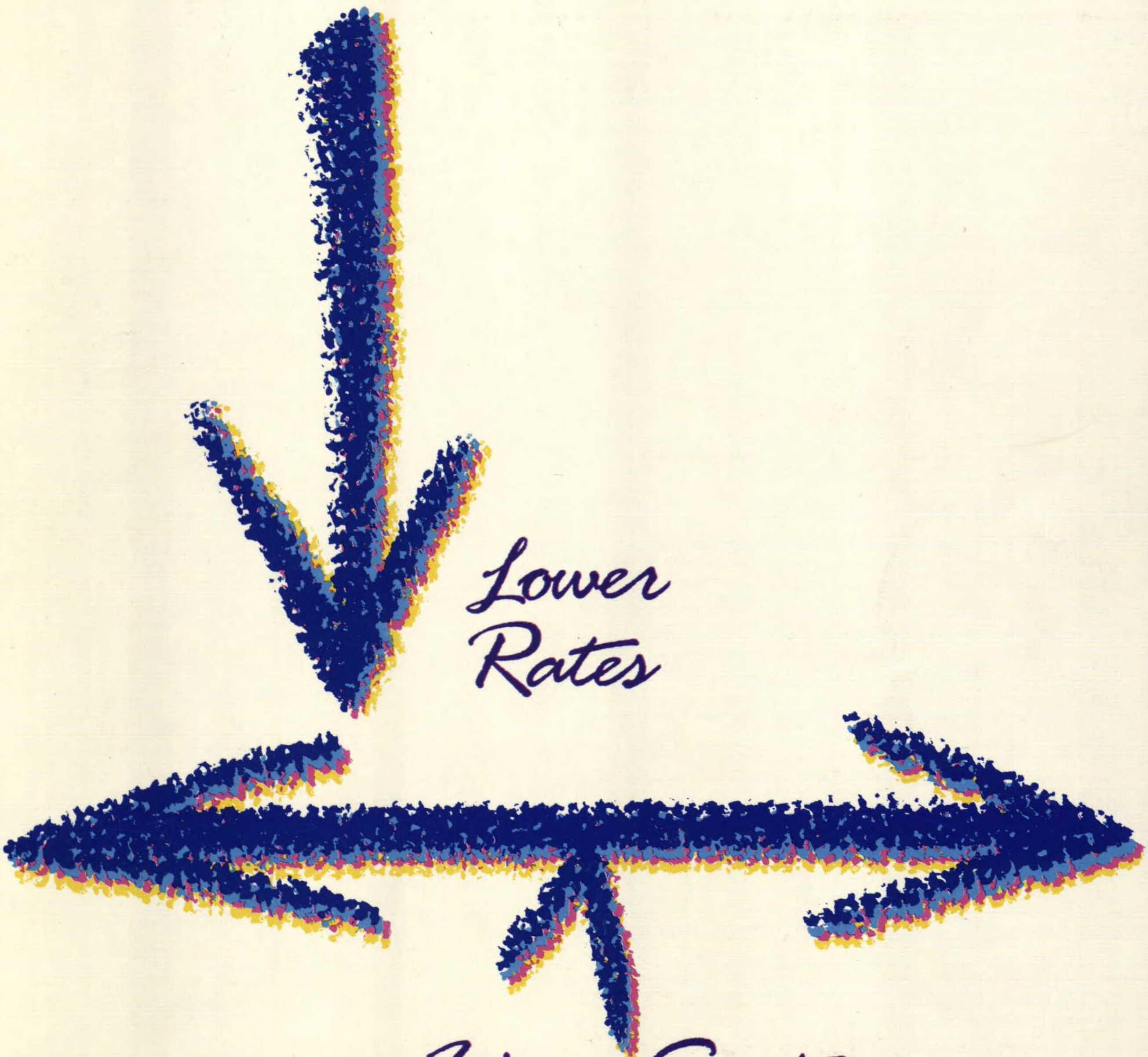
e White Paper
Tax Reform 1987

June 18, 1987

The Honourable
Michael H. Wilson
Minister of Finance



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Introduction

The objective of the tax system is to raise the revenues needed to pay for publicly funded programs, and to do this in a way that supports economic growth and is fair to all Canadians.

How we are taxed, and how much we are taxed, is of critical importance to all Canadians. It directly affects our personal financial circumstances. It affects how well our economy functions in providing investment, growth and jobs. It determines our capacity to fund public programs to enhance our collective well-being and to support those among us who need assistance.

There are compelling reasons to reform Canada's tax system. It is unfair in many ways. It is hurting Canada's ability to grow and create jobs. It is becoming an increasingly unreliable source of revenues.

Since September 1984 the government has acted in many ways to strengthen Canada's economy. A healthy and growing economy is fundamental to achieving the goals Canadians seek: more and better jobs, greater opportunities, a higher standard of living, and the ability to support the cultural diversity and social programs that distinguish us as a mature and caring nation.

In setting its *Agenda for Economic Renewal*, the government identified four challenges:

- to restore fiscal responsibility,
- to remove obstacles to growth,
- to foster investment, innovation and competitiveness, and
- to provide greater assistance to those Canadians who truly need it.

The government's proposals for tax reform – a fairer system with lower rates – will contribute to meeting each of these challenges.

The reformed tax system will be fairer. The vast majority of individuals will pay less tax. Higher-income individuals and profitable corporations that currently pay a disproportionately small share of taxes will see their tax burden increase. The seriously flawed federal sales tax will be replaced by a multi-stage sales tax. The new tax will be made fairer by an enriched refundable tax credit that will alleviate the burden on low-income families and individuals.

The reformed tax system will increase incentives to work and invest. Lower tax rates will enable Canadians to keep more of every dollar they earn, to spend or save as they see fit.

The reformed tax system will remove obstacles to growth and job creation. By removing specific preferences, broadening the tax base and lowering tax rates, the proposed tax system will ensure that decisions to save and invest are based on real economic considerations, not tax considerations. Our income tax system will become competitive with those of our major trading partners. And sales tax reform will eliminate the burdens that the existing tax puts on exporters and on Canadian businesses that are trying to compete with imports in our own markets.

The reformed tax system will contribute to responsible fiscal management. Over all, revenues from the new tax system will not be significantly different from the revenues that the existing system would have produced, but the burden will be shared more fairly. The risks of revenue erosion will be lessened by reducing some preferences, eliminating others, and introducing more effective anti-avoidance provisions. Over the longer term, the proposals will improve economic growth, yielding greater tax revenues.

The reform proposals will be implemented in two stages. In the first stage, the income tax system will be reformed, effective for the 1988 tax year. A new sales tax system will be implemented in the second stage, following consultations with provincial governments and other interested Canadians on which variant of the multi-stage tax proposed in this paper will best serve Canada's interests. The new sales tax will be accompanied by further changes to the income tax system in the second stage of tax reform.

This White Paper sets out the objectives of tax reform, and provides an overview of the proposals for reform of the income and sales tax systems, along with their impact on households and businesses in Canada. The paper concludes with an assessment of the impact of tax reform on Canada's economic performance, the federal government's fiscal position and the consequences of the proposals for provincial governments.

A more detailed description of the proposals and their impacts is found in the two background papers on the income tax and sales tax and in the paper describing the medium-term economic and fiscal outlook for the Canadian economy.

1. The Objectives of Tax Reform

The tax reform proposals have been designed to meet five broad objectives:

- Fairness
- Competitiveness
- Simplicity
- Consistency
- Reliability

The fairness of the tax system should be increased.

There are a number of important areas in which the fairness of the tax system needs to be improved.

Higher-income individuals and profitable corporations must carry a larger share of the income tax burden than they currently do. This objective will be achieved by broadening tax bases through eliminating and reducing selective preferences, by raising the income threshold at which individuals begin to pay personal income tax and by substantially enhancing the sales tax credit for lower- and middle-income households. More effective rules to prevent artificial tax avoidance, and improved reporting requirements to identify tax avoidance and evasion, will also help meet this objective.

Individuals in similar economic circumstances should be taxed more equitably than they now are. Where they are not, there should be valid reasons for different treatment. The reduction of selective preferences will help to achieve this objective.

The income tax system should be better integrated with the social transfer system to assist those most in need. Converting tax exemptions and some deductions into tax credits will assist lower- and middle-income Canadians, furthering the objective of fairness.

The personal income tax and the sales tax, taken together, should become more progressive than they now are. To help achieve greater fairness, the two systems will be better integrated through a substantially enhanced refundable sales tax credit.

The tax system should encourage competitiveness, growth and jobs.

To achieve this objective the tax system should have lower rates and a broader base.

Special preferences help some taxpayers, but at the cost of higher tax rates that hurt others. As a general principle, the government should refrain from using the tax system to subsidize particular types of investment activity. Such subsidies introduce distortions in economic decisions and inequities among taxpayers. Where incentives remain, they should serve well-defined objectives, and should endeavour not to bias choices among similar types of economic activity.

Lower tax rates are the best way to reward success, by letting Canadians keep more of every dollar they earn to spend or save and invest as they see fit. Lower marginal tax rates also provide a continuing benefit to Canadians as their incomes grow in the future. This continuing benefit constitutes a general and potent incentive to engage in productive activity that will support economic growth, international competitiveness and job creation.

It is important that our tax system not place Canadians at a competitive disadvantage in domestic or international markets. We must recognize the competitive reality of tax systems in other countries.

At the same time, the tax system must remain sensitive to the Canadian commitment to greater regional equality through economic development. Nor can the tax system ignore Canada's need to encourage a high rate of domestic savings to finance the investment required to develop the country's potential. It must foster entrepreneurship and a willingness to take risks that will help build a more dynamic and innovative economy. The tax reform proposals put forth in this White Paper strike a balance between removing specific preferences and recognizing Canadian priorities and needs.

The tax system should be simpler to understand and comply with.

A simpler tax system will ease compliance and reinforce the self-assessment principle that is the foundation of our tax system.

In a society as advanced and diverse as Canada, the tax system will, of necessity, be complex. But it can be made easier for individuals to understand and for businesses to comply with. A simpler structure of tax rates on income and fewer invidious borders between products taxed differently under the sales tax will contribute to meeting this objective.

A tax system with fewer special preferences will also be more straightforward and more readily understood by Canadians.

The tax system should be internally consistent and consistent with other government programs.

Most taxes are ultimately borne by individual Canadians, in their roles as employees, investors, shareholders or consumers. Therefore, it is important that the personal, corporate and sales tax structures be well integrated and internally consistent to assure Canadians that the total tax burden is fairly shared and that the system is economically efficient. Consistency also enhances understanding of the system and facilitates compliance and administration.

The tax system should also complement and assist the implementation of other programs of government. In particular, it should enhance the bilateral and multilateral trade initiatives by improving Canada's competitiveness. Tax reform will contribute to these initiatives by lowering income tax rates, promoting more efficient allocation of resources and removing the biases in the current federal sales tax which work against our exports and favour imports.

It should assist in improving the overall structure of our social transfer programs and related tax provisions in line with the principles set out in the February 1986 budget. Converting exemptions to credits assists those most in need while reducing the after-tax value of benefits going to higher-income Canadians. Together, they make the system fairer now and provide additional building blocks to improve income security programs in a way that will better meet the needs of Canadians through the 1990s.

The tax system should provide a more reliable and balanced source of revenues to finance essential public services.

The basic objective of the tax system is to raise revenues to pay for publicly funded programs. To provide the high standard of services to which the government is committed, the tax system must yield predictable and reliable revenues derived from a fair, broad and secure tax base.

The intent of the government is neither to increase nor to decrease tax revenues as a direct result of tax reform, but to ensure a more predictable and secure revenue base.

By removing special preferences and curbing opportunities for artificial tax avoidance in both the income and sales tax systems, the government can have greater confidence that its revenue goals will be achieved. By improving the performance of the economy over the medium term, tax reform will strengthen growth, thereby helping to restore better balance between revenues and expenditures.

Balance and stability should also be achieved by reducing excessive dependence on personal income taxes, while increasing reliance on the corporate income tax and a reformed sales tax system.

Balancing Objectives

The comprehensive tax reform proposals set out in this White Paper are aimed at achieving an appropriate balance among these objectives. Balance requires recognizing that trade-offs and choices are inevitable. The challenge of tax reform is to select those measures which together strike a balance that reflects the importance Canadians themselves place on the objectives of fairness, competitiveness, simplicity, consistency and reliability.

In developing these proposals, the government has benefited enormously from the ideas, suggestions and recommendations submitted by representative associations, businesses, labour and individual Canadians. Extensive discussions on the broad outlines and, in many cases, specific details of the proposals, have been held with provincial Ministers of Finance. The proposals have benefited from this federal-provincial consultative process and the government appreciates the constructive spirit and open and positive manner in which these discussions have taken place.

2. The Need for Tax Reform

The Income Tax

The Income Tax Act is in need of major reform to meet the objectives outlined above. However, the government believes that the basic characteristics of the income tax system remain sound.

- For individuals and corporations, the current concepts of income from all sources and of capital gains remain valid as the bases for taxation.
- It is appropriate in computing taxable income that deductions continue to be allowed for expenses incurred in earning income.
- The nominal values of income and capital gains remain the practical basis for their measurement for tax purposes. Deductions, credits and rate bracket thresholds should continue to be adjusted periodically to reflect, but not necessarily fully compensate for, inflation.
- Annual income remains the appropriate basis for taxation with adjustments for contributions to pension and retirement savings plans and for carry-back or carry-forward of economic losses.
- Tax should continue to apply separately to corporations and individuals, with integration between the two systems.
- For the personal income tax, it is appropriate that the income of the individual remain the primary measure of ability to pay. The refundable child and sales tax credits should, however, continue to be based on net income of the family as currently measured, since this is the appropriate measure of need for such refundable credits.
- The average rate of tax should increase as income increases so that the higher the income of an individual, the greater the fraction of that income he or she will pay in tax.
- Taxpayers in similar economic circumstances should be subject to similar rates of tax.

These are the basic characteristics of our income tax system and will remain so after reform.

Over most of the 1970s and early 1980s, these characteristics were eroded by the introduction of a very large number of special tax preferences into the personal and corporate income tax systems. Each of these, in its own context, was judged at the time to be a useful and innovative approach to addressing a particular concern. Taken together, however, the proliferation of special tax preferences has put increasing pressure on the equity, efficiency and revenue stability of the income tax system. As a result, the income tax system is not serving Canada, or Canadians, as well as it should.

Due to the growth of preferences, by 1984, taxable income under the personal income tax represented only 60 per cent of assessed income. Much of the other 40 per cent was accounted for by personal exemptions. However, special deductions constituted 14 per cent of assessed income in 1984 – up from 9.5 per cent in 1972.(1) Had these special deductions remained a constant share of assessed income, over $10 billion more income would have been taxable in 1984.

This growth in preferences has not only led to an erosion of revenues; it has also contributed to growing inequity among taxpayers with similar incomes. This is reflected in Table 2.1. For example, in 1984, 52 per cent of taxpayers with incomes between $75,000 and $100,000 paid tax at an average federal rate between 20 and 25 per cent. But 21 per cent of taxpayers in this income range paid tax at rates of less than 15 per cent.

Over the past decade, there has been an increased incidence of high-income individuals paying little or no tax. For example, the number of non-taxable returns filed by individuals with 1984 income in excess of $100,000 (adjusted to reflect average income growth over the past decade) increased from 305 in 1975 to 1,665 in 1980 and 1,830 in 1984. In 1984, 4 per cent of individuals with more than $100,000 in income paid no tax at all and 23 per cent of individuals in the same income group paid tax at a rate of 15 per cent or less.

Similar trends have developed in the corporate income tax, due to special rate reductions, tax credits, accelerated capital cost allowances, special accounting provisions and growing tax avoidance. Over the period from 1971-1975 to 1981-1985, the average tax rate on corporations fell from 26.1 per cent to 23.6 per cent of total corporate profits of all corporations. Had the average effective tax rate remained at 26.1 per cent, annual corporate tax revenues would have been almost $1 billion higher. These preferences have not only led to an erosion of the tax base; they have also resulted in substantial variation in effective corporate tax rates across sectors. Under the current system, average federal corporate tax rates as a percentage of financial statement income, for profitable corporations only, range from a low of 14.5 per cent in the finance, insurance and real estate sector to a high of 24.5 per cent in the wholesale trade sector (Chart 2.1).

While almost all financial statement income of profitable firms in the retail trade industry was subject to tax, less than 50 per cent was subject to tax in the mining and financial services industries (Chart 2.2).

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(1) These deductions are described in Chapter 2 of "Income Tax Reform".

Table 2.1

Distribution of Taxpayers by Income and Average Federal Personal Income Tax Rate, 1984

Total income[1]	Number of taxfilers	Per cent of total taxfilers	Percentage distribution of individuals by average tax rate[2]: No tax[3]	Average rate 0-5	Average rate 5-10	Average rate 10-15	Average rate 15-20	Average rate 20-25	Average rate 25-30	Average rate 30+	Total
($ thousand)	(thousand)		(per cent)								
0 – 10	5,813	37.4	73	18	9	–	–	–	–	–	100
10 – 20	4,178	26.9	5	16	53	26	–	–	–	–	100
20 – 30	2,752	17.7	1	3	25	69	2	–	–	–	100
30 – 40	1,584	10.2	1	2	7	66	24	–	–	–	100
40 – 50	661	4.3	1	2	5	40	51	1	–	–	100
50 – 75	396	2.5	2	2	5	15	64	12	–	–	100
75 – 100	83	0.5	2	3	5	11	26	52	1	–	100
100 – 150	48	0.3	4	4	5	10	16	40	22	–	100
150 and over	33	0.2	4	5	5	9	16	19	34	8	100
Total	15,552	100.0	29	12	23	28	7	1	–	–	100

(1) Total income is defined as income from all sources, including full capital gains and cash dividends (i.e., before the gross-up), but before any deduction for tax incentive provisions such as capital cost allowance on MURBs and films, and the exploration and depletion deductions for investments in the resource sector. Because of difficulties in separating incentive deductions from other current expense deductions, total income is computed without allowing net losses from any one source to reduce a taxpayer's income from other sources.

(2) Average tax rate is defined as federal tax payable before the child tax credit, divided by total income. The federal tax reduction in effect in 1984 has since been phased out and it is not included in the computations.

(3) Includes taxfilers with federal tax payable of less than $10 or 0.1 per cent of income.

Source: "Income Tax Reform", Table 2.2, p. 10.

Tax rates on income from a new investment ranged from a low of minus 15.1 per cent in the mining sector to a high of 37.8 per cent in the wholesale trade sector (Chart 2.3).

In both the personal and corporate income tax systems, special preferences have led to revenue erosion and made the system less fair.

But the proliferation of special preferences, and the increase in their use, has had other damaging impacts as well. They have, paradoxically, made the income tax system much less effective in supporting economic growth and have seriously increased the complexity of the system.

As special incentives become more commonplace, each has become, by definition, less "special" and the effectiveness of each in accomplishing its original purpose has diminished. Over all, it is clear that the shotgun approach that has come to characterize the use of incentives in the income tax system is distorting and biasing investment decisions. Tax rates higher than necessary, together with special incentives, give tax planning rather than future profitability too large a role in investment decisions. As a result, investment capital is too often diverted from endeavours that best serve growth, development and job creation to projects that minimize investors' tax liabilities.

As special preferences have become more widespread, the tax system has become much less easy to understand. More and more Canadians are finding it necessary to seek professional advice to complete their income tax returns. For most, this represents a way to cope with a more complicated tax form, more special-purpose schedules, and an increasingly complex tax guide. For many, however, it reflects a growing trend to aggressive tax planning in an effort to exploit the preferences in the tax system so as to minimize their tax liabilities.

The growth of preferences has undermined public respect for the tax system and has led many Canadians to question its basic fairness. A lack of respect for the integrity and fairness of the tax system is a particularly serious problem for Canada, where the tax system rests upon the foundation of self-assessment and voluntary compliance.

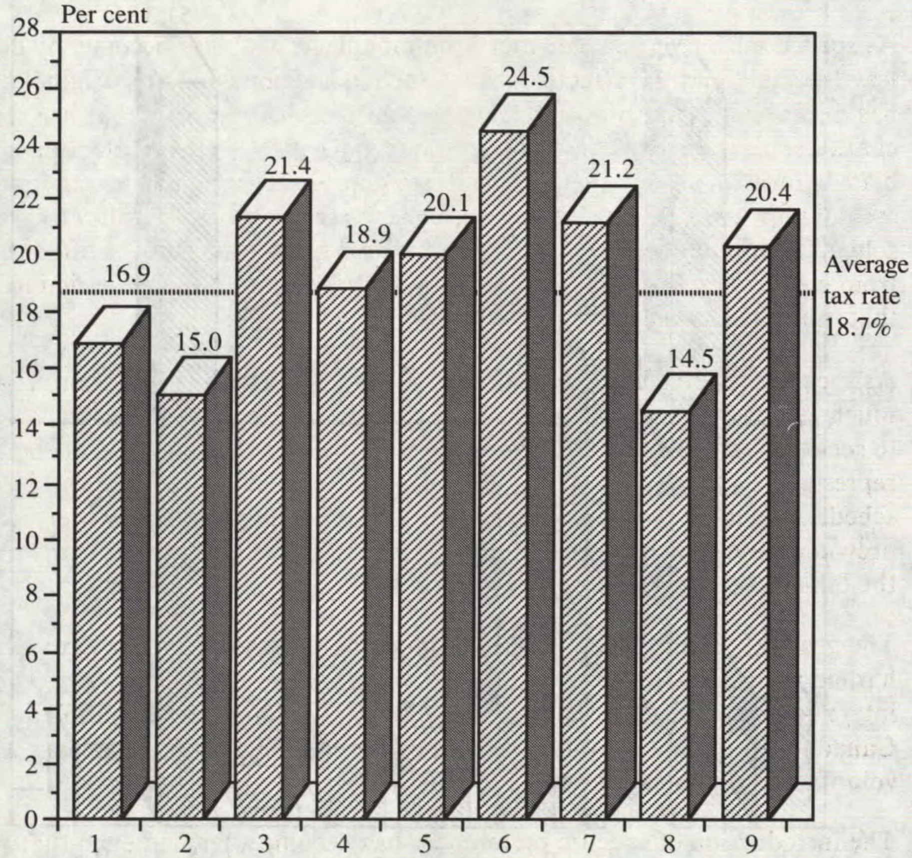
The introduction of specific preferences has become a phenomenon that feeds on itself. Each new special-purpose incentive has had the effect of increasing the demand for similar tax concessions from other interests who feel they have a strong case for equally favourable treatment. The result is increasing complexity and tax rates that are higher than necessary to raise a given amount of revenue.

In each of these three critical dimensions – the fairness of the system, the impact of the tax structure on economic efficiency, and growth and the stability of the revenue base – the Canadian income tax system is failing to deliver what Canadians have a right to expect.

In sum, an income tax system with high rates relieved by an unfair patchwork of special incentives is not what Canada needs. What Canada needs is a fundamentally different approach: lower tax rates and a broader, fairer tax base.

Chart 2.1

Average Federal Corporate Taxes as a Percentage of Financial Statement Income, by Sector [1]



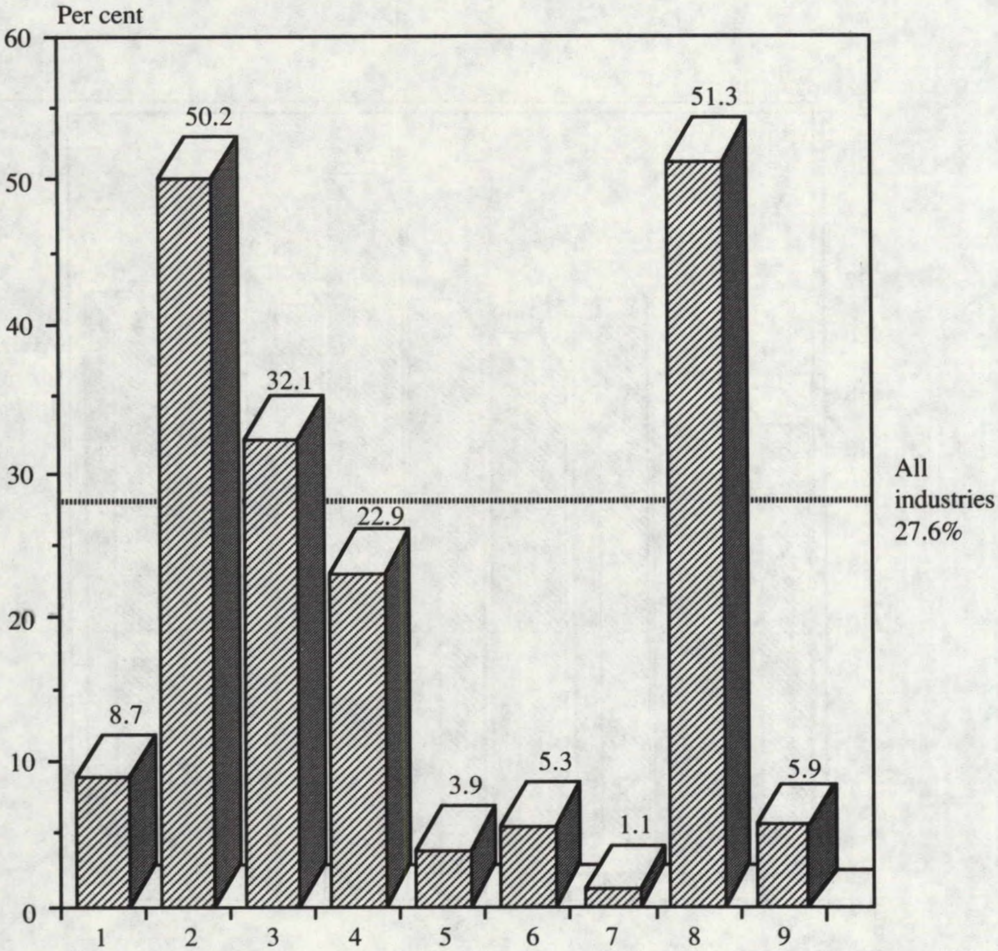
1- Agriculture, forestry and fishing
2- Mining
3- Oil and gas
4- Manufacturing
5- Construction
6- Wholesale trade
7- Retail trade
8- Financial institutions, insurance and real estate
9- Services

(1) The data are based on various years chosen to be representative of profit and investment performance.

Source: "Income Tax Reform", Chart 2.3, p. 14.

Chart 2.2

Percentage of Income of Profitable Firms by Sector, Which is Not Taxed[(1)]



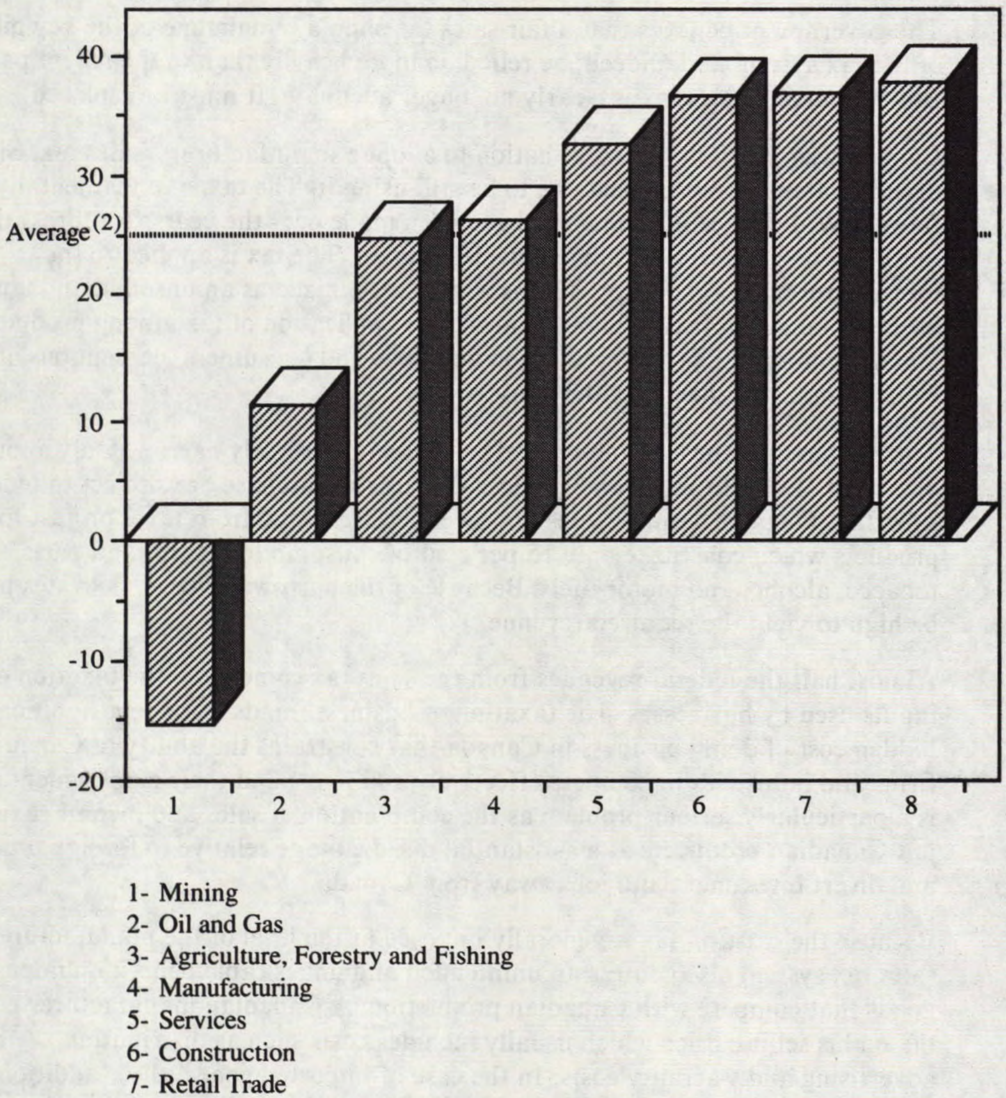
1 - Agriculture, forestry and fishing
2 - Mining
3 - Oil and gas
4 - Manufacturing
5 - Construction
6 - Wholesale trade
7 - Retail trade
8 - Financial institutions, insurance and real estate
9 - Services

(1) The data are based on averages for various years selected to be representative of profit and investment performance.

Source: "Income Tax Reform", Chart 2.5, p. 16.

Chart 2.3

Current Federal/Provincial Tax Rates on New Investment for Large Corporations, by Industry Group (1)



1- Mining
2- Oil and Gas
3- Agriculture, Forestry and Fishing
4- Manufacturing
5- Services
6- Construction
7- Retail Trade
8- Wholesale Trade

(1) Provincial tax rates are those in effect May 1, 1987.

(2) Total non financial sector.

The Federal Sales Tax

The faults of the federal sales tax have been identified and documented in numerous studies over the past five decades, beginning with the Royal Commission on Dominion-Provincial Relations (the Rowell-Sirois Commission) in 1940, continuing in 1966 with the Royal Commission on Taxation (the Carter Commission), and most recently with the Federal Sales Tax Review Committee (the Goodman Committee) in 1983. These and other reviews have expressed serious concerns about the structure of the federal sales tax and have recommended substantial change.

The government believes that a fair sales tax should remain one of the key pillars of the tax system and, indeed, be relied on more heavily than in the recent past. But the current sales tax is clearly no longer adequate. It must be replaced.

Canada was the first industrial nation to adopt a manufacturers' sales tax. Six decades later, we are the last one to be still using it. The tax is fundamentally flawed. While piecemeal changes have been made over the years to address the most pressing concerns, its inadequacies remain. The tax is applied to the manufacturer's selling price. This is widely recognized as an unsound and unstable basis for taxation. It results in the arbitrary application of tax among products and among sectors. It distorts production decisions and consumers' perceptions of the value of many of the goods they buy.

The tax base for the existing federal sales tax is extremely narrow. Only about one-third of all the goods and services Canadians purchase are subject to federal sales tax. Forty per cent of sales tax revenues are raised from taxes on just four products which constitute only 15 per cent of consumption: autos and parts, tobacco, alcohol and motor fuels. Because of the narrow tax base, tax rates must be high to yield the required revenue.

Almost half the federal revenues from the sales tax come from the taxation of inputs used by businesses. The taxation of business inputs leads to a significant hidden cost of doing business in Canada that constrains the ability of Canadian firms and industries to compete effectively and to expand their employment. This is a particularly serious problem as the combination of sales and income taxes can put Canadian producers at a substantial disadvantage relative to foreign producers and divert investment and jobs away from Canada.

Because the existing tax is generally imposed at the level of the manufacturer, the sales tax system also confers an unintended and undesirable benefit on imported goods that compete with Canadian production. A Canadian manufacturer pays tax on his selling price which usually includes costs such as distribution, advertising and warranty costs. In the case of imported goods, these additional costs are typically incurred by the Canadian importer rather than the foreign manufacturer and they are therefore not taxed. Studies show that, on average, domestically produced goods bear an effective rate of federal sales tax that is one-third greater than the effective rate on imported goods.(2)

(2) See Chapter 2 of "Sales Tax Reform".

While this situation has persisted for some time, the damage it inflicts on the Canadian economy is growing more serious in the challenging trading environment of the 1980s. If we are to capture the full benefit of new trading arrangements and to compete successfully in world markets, we need a sales tax system more in keeping with the competitive challenges which are ahead.

The current federal sales tax also works to the detriment of consumers. Through the hidden tax on business inputs, it increases consumer prices for many goods that are not directly taxed. Even for manufactured goods that are taxed directly, the current system leads to price pyramiding at the consumer level. Wholesale and retail mark-ups are often applied to prices that already reflect the federal sales tax. As a result of the inadequacy of the federal tax, consumers pay higher prices than they would if the same federal tax revenues were collected at the retail level.

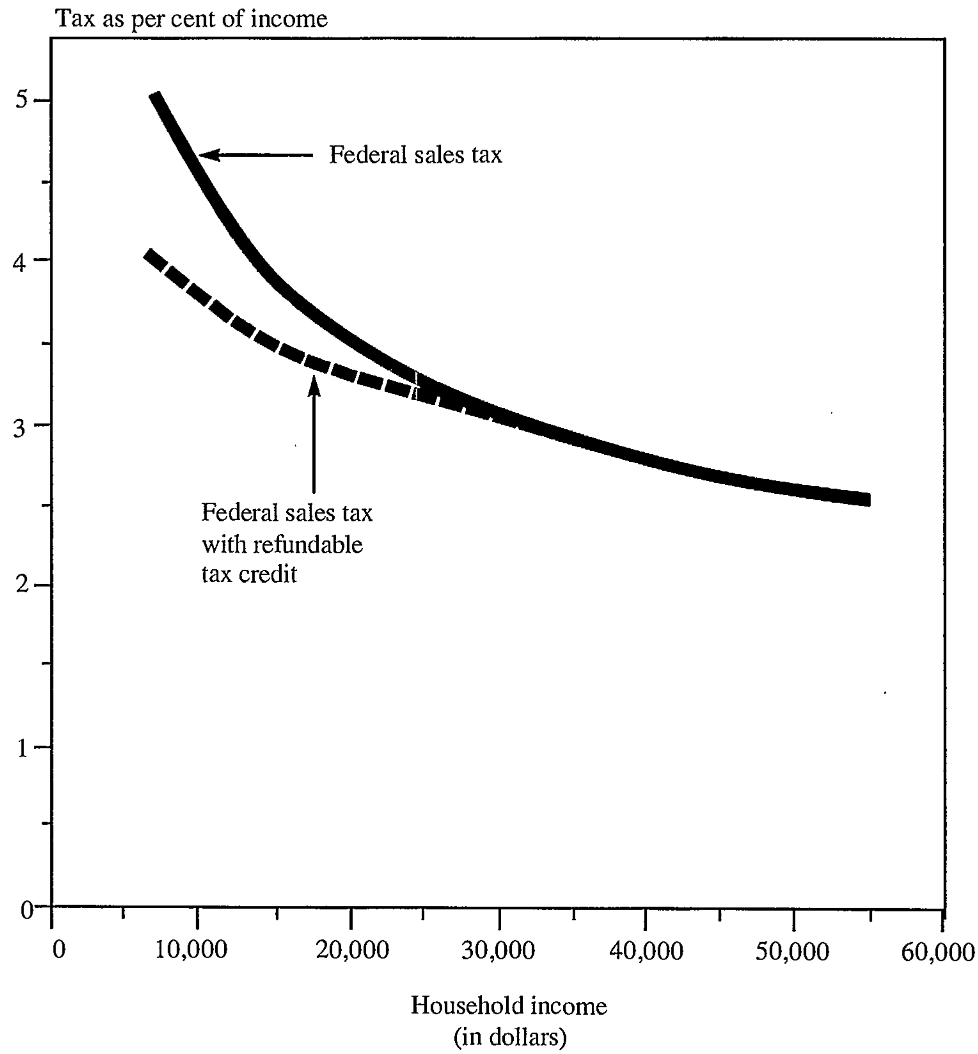
Because of the narrowness of the base, and the competitive disadvantages that the tax imposes on Canadian producers, there has been increasing pressure over the years by Canadian manufacturers to deal with Revenue Canada to try to achieve some semblance of fairness and competitive balance. Each year, Revenue Canada now issues more than 22,000 rulings and interpretations about the application of the tax. Thousands of taxpayers avail themselves of the special arrangements allowed by Revenue Canada to establish the value on which they can base their payments. While this has helped relieve some of the most difficult problems of competitive equity in the marketplace, it has also made the current system extremely complex to administer and, in many cases, capricious in its impact. As a result, competitive products do not bear the same effective rate of federal sales tax as a percentage of the final price to consumers.

As a result of its complexity and archaic legal structure, the federal sales tax has become subject to increasing avoidance by taxpayers, and recent court decisions have cast serious doubt on the ability of Revenue Canada to rely on existing provisions of the Excise Tax Act to deter avoidance. For this reason it is likely that manufacturers will increasingly be able to limit their tax liabilities. Such actions would represent a substantial erosion of the tax base. They would further detract from the uniform application of the tax and, thus, the fairness of the system itself.

Finally, and most importantly, the distribution of the burden of the current federal sales tax is unfair; low-income earners generally pay more sales tax as a percentage of their earnings than do people with higher incomes. Governments have tried to compensate for this by exempting from tax items such as clothing, footwear, foods, and heating fuels. But this has not appreciably reduced the problem. It has only led to higher rates on all other goods, including other goods purchased by low-income earners. The refundable sales tax credit introduced in 1986 is designed to help overcome this problem. The impact of the credit is illustrated in Chart 2.4. Notwithstanding the innovation of the credit however, the basic problem of this distribution can only be solved by a complete overhaul of the sales tax system and its integration with the income tax system through a significantly enhanced refundable and prepaid sales tax credit.

Chart 2.4

Distributional Impact of the Current Federal Sales Tax With and Without Refundable Sales Tax Credit



Note: The current sales tax credit is $50 per adult and $25 per child, reduced by 5 cents for every dollar of income in excess of $15,000.

Source: "Sales Tax Reform", Chart 2.5, p. 21.

The inadequacy of the sales tax has been recognized for years, and for years governments have discussed and debated how best to replace the sales tax with a better system. The time has come to move this debate forward.

Conclusion

The problems with our tax system – both income taxes and sales taxes – are not new. Over the past decade they have grown to the point where they seriously compromise opportunities for economic growth, development and job creation. They are increasingly undermining the foundation of equity on which a well functioning tax system must rest. The purpose of tax reform is to improve our tax system so that Canadians benefit from a fairer, more understandable system that encourages initiative, strengthens growth and creates jobs.

3. A Comprehensive Approach

Since the beginning of its mandate, the government has been acting to improve the structure of the tax system. In September 1984, work was begun to develop options to restructure the corporate income tax, to design a minimum income tax, and to reform the federal sales tax. It was decided, however, that reform should proceed in a gradual fashion so as not to create a period of uncertainty that might harm Canada's economic performance. This approach was set out in the May 1985 budget.

In line with this approach, a number of actions have been taken to improve the fairness of the system, curb opportunities for tax avoidance, provide a better tax framework for growth and move the process of tax reform forward. It is useful to review them briefly. They indicate the direction taken so far and the progress that has been made. Equally important, the nature and frequency of these actions provide a sense of the pressure the existing tax system has been under for some time.

Incremental Reform: 1985-1986

In the budget of May 1985, the government announced a number of measures to reduce or eliminate special preferences. These included:

- proposals for a minimum tax regime for high-income individuals, which became effective at a federal-provincial rate of 25 per cent in the 1986 taxation year;
- the elimination of income-splitting among family members through the use of interest-free loans, in order to minimize tax;
- the elimination of the registered home ownership savings plan (RHOSP);
- the removal of tax shelters based on investments in yachts, recreational vehicles and similar properties;
- the termination of the scientific research tax credit, a special incentive which had been subject to severe abuse;
- proposals to restructure the corporate tax system; and
- a series of measures to help maintain the revenue base of the current federal sales tax which was eroding due to its archaic legal structure.

In the period following that budget, actions were taken to:

- stop the so-called "carve-out" transactions in the oil and gas sector, whereby profitable corporations transferred resource income to corporations with losses or tax-exempt entities in order to avoid tax;
- prevent the use of trusts to market securities issued in such a way that income and capital returns to investors were distributed tax-free;
- end the use of partnerships in corporate takeovers to increase tax deductions through the so-called "partnership step-up" rules; and
- tighten rules so that pension plans could not avoid the limits on foreign property investments.

In the February 1986 budget, further changes to prevent erosion of the revenue base and to improve tax fairness were introduced. These included:

- new rules restricting the tax-credit and business-loss claims of investors in limited partnerships to the amount of their investment at risk;
- provisions to remove the tax advantage of salary deferral arrangements; and
- introduction of a refundable sales tax credit to aid lower-income Canadians.

As well, the February 1986 budget introduced a series of measures to begin restructuring the corporate tax system, along the lines set out in a May 1985 discussion paper. As a result, investment tax credits are being reduced in some cases and eliminated in others, and the inventory allowance was removed. This base broadening is being accompanied by tax rate reductions.

Since February 1986, further actions have included measures to:

- deny the tax-free treatment of intercorporate dividend transfers for certain categories of preferred shares designed to transfer unused tax losses to profitable corporations in order to shelter their income from tax;
- prevent a number of other techniques designed to transfer losses and other tax deductions from companies who could not use them to profitable corporations who could use them to reduce tax;
- prevent the use of commercial trusts to avoid tax, in a manner unintended by the law;
- correct some of the competitive distortions inherent in the federal sales tax by broadening the base and moving the point of tax from the manufacturer to the wholesale level for a limited number of goods.

The list of actions set out above reflects, in graphic terms, the continuing and intense pressure the income and sales tax systems have come under during the course of the past few years and the policy reactions that have been necessary.

The imperative of restoring prudent management to government finances and controlling the massive build-up of the public debt has required revenue increases that have also tilted the balance among tax sources and highlighted the structural problems with the tax system. Although the primary focus in reducing the deficit since 1984-85 has been on restraining expenditure on government programs, it has also been necessary to raise taxes. In addition to the measures outlined above to reduce or remove preferences and eliminate opportunities for tax avoidance, major measures to achieve higher revenues have included increases in sales tax rates, modification of the indexing provisions in the personal income tax system, and surtaxes on individual taxpayers and corporations.

These actions have helped restore overall revenue yields, measured as a share of gross domestic product, to levels more representative of the early 1970s and more appropriate to our fiscal needs. But higher tax rates have aggravated the inequities, the economic distortions, and the incentives for tax avoidance that had grown in significance as special preferences became more widespread.

Considerations Leading to a Comprehensive Approach

As it became increasingly apparent that the Canadian tax system was not performing many of its functions as well as it should, it became clear that the process of evolutionary and incremental reform, which had been in progress, would need to be greatly accelerated. It also became evident through this period that some of our major trading partners, whose tax systems suffered many of the same deficiencies as Canada's, were moving forward more aggressively and more comprehensively with actions to reform their tax systems and, in particular, to lower their tax rates. In an increasingly interdependent world, it is important not to allow Canada's tax system to put our traders, businesses, investors and highly skilled individuals at a competitive disadvantage with other countries.

As well, as work progressed on options for sales tax reform and on the review of our social transfer programs and related tax provisions, it became apparent that significant changes in either of these areas, to be fair, would require consistent integration with the personal income tax.

In light of these considerations, the government reconsidered its incremental approach to tax reform and, in July 1986, the Minister of Finance announced the government's intention to proceed as quickly as possible with comprehensive tax reform.

Comprehensive reform is an opportunity to move towards a fully integrated and internally consistent tax system that will strike a better balance between the sales, corporate and personal income taxes. This approach offers greater scope to achieve the significant changes necessary to support the social and economic objectives of Canadians because of the opportunities it provides to balance change in one tax area with change in others. For example, comprehensive tax reform provides scope to raise corporate income taxes to help fund personal tax reductions.

The greater flexibility offered by a comprehensive approach is not limited solely to changes among tax areas, it also provides more opportunities for change within individual areas. Comprehensive reform lowers tax rates by broadening tax bases. In turn, lower rates compensate for the specific preferences reduced or lost in the interest of achieving the broader base. This kind of balance pays important dividends. By making lower tax rates possible, it strengthens incentives and stimulates economic efficiency and growth. At the same time, lower rates reduce the incentive for tax avoidance and provide the government with more stable and predictable revenues needed to fund public services.

Lower tax rates are a key objective of the government's approach to tax reform. Comprehensive reform provides the scope needed to achieve it.

Balance means treating tax reform as a package. Each change to the tax system will affect millions of Canadians – most favourably, some unfavourably. It will be essential, as we move forward to build a better tax system, that Canadians not lose sight of the overall thrust and benefit of the package by concentrating on individual measures. The benefits of tax reform must be assessed over all – with change to any one element of the system set in the context of changes to all the others.

Reform on this scale is a massive undertaking. It will affect every Canadian now and for many years to come. Although the changes to be introduced into the corporate and personal income taxes are major, the two systems will continue to be based on foundations familiar to individual Canadians, the business community and tax professionals. In contrast, the area of most fundamental change will be the sales tax system where it is proposed that the current tax be replaced by an entirely new one, involving new principles and operations.

The fact that the sales tax system will be entirely new dictates the manner in which it must be implemented. Self-assessment by taxpayers is basic to the Canadian tax system. Therefore, to ensure a smooth transition to the new system, individual Canadians and businesses who must comply with it should have a full opportunity to become more familiar with the tax and to gain a fuller understanding of its operation, before it is implemented. This will also provide time for individuals, tax professionals and the representatives of key social and economic sectors to work with government to finalize the details of its application.

An entirely new sales tax offers an opportunity to extend the reach of tax reform beyond the federal level to achieve truly national reform. By working with the provinces, it may be possible to consolidate their sales tax systems with that of the federal government in one national sales tax system. Accommodating this opportunity and providing the time Canadians need to adopt a new sales tax calls for a measured approach to the implementation of sales tax reform.

As a result, the government has decided to implement comprehensive tax reform in two stages. Changes to the personal and corporate income tax systems will be undertaken in the first stage. Because they are based on familiar principles, they can proceed more quickly. The government proposes that they commence in the 1988 taxation year. In addition, in this stage modifications to the existing sales tax will be made to deter avoidance and broaden the federal sales tax base. The interim sales tax measures will enhance compliance and alleviate some competitive distortions. By contributing additional revenues they will also permit the income tax reductions of the first stage of tax reform to proceed in a manner that is consistent with the government's principles of responsible fiscal management. Along with these sales tax measures, the existing refundable sales tax credit will be increased.

Sales tax reform requires building an entirely new system. It will be put in place in the second stage of tax reform and will be accompanied by a significantly enriched refundable sales tax credit. The eligibility threshold for the credit will be raised, assisting more Canadians. The credit will be prepaid. At the same time the existing 3-per-cent personal and corporate income surtaxes will be removed and there will be further personal income tax reductions for middle-income Canadians. The second stage of tax reform will proceed after the consultations with provincial governments and interested Canadians necessary to ensure the smooth implementation of the multi-stage tax.

4. Proposals for Reform

Overview

The major thrusts of the proposals for reform are as follows:

Personal Income Tax

- Tax rates will be lowered.
- The number of tax brackets will be reduced from ten to three.
- Personal exemptions and many deductions will be converted to credits. In so doing, the tax value of the basic, married, age and disability credits will be significantly enhanced for the majority of Canadians.
- The tax base will be broadened by reducing or eliminating a number of deductions, including those for films, multiple unit residential buildings (MURBs), meals and entertainment, automobiles and home office costs.
- The lifetime exemption for capital gains will be held at its 1987 level of $100,000 ($500,000 for farmland). Small business shares will qualify for a $500,000 exemption as of January 1, 1988. The portion of capital gains that is included in taxable income will be increased.

Corporate Income Tax

- The statutory tax rate will be reduced.
- Rates of capital cost allowance will be reduced to broaden the tax base and more closely reflect economic depreciation.
- Special tax provisions for the finance, insurance and real estate sectors will be modified to more closely reflect accounting for financial statement purposes.
- Earned depletion will be phased out, but the flow-through share mechanism will be maintained.
- Deductions for meal and entertainment expenses will be limited.

- Tax-motivated financing by non-taxable companies through preferred shares will be limited.

- The portion of capital gains included in taxable income will be increased.

Sales Tax

- A multi-stage tax on a broader base and at a lower rate will replace the current federal sales tax.

- A significantly enhanced refundable sales tax credit is proposed.

These proposals are described in the remainder of this chapter. They are set out in more detail in the background papers "Income Tax Reform" and "Sales Tax Reform".

A. Proposals for Reform: Stage One

Providing general incentives through lower income tax rates is a cornerstone of the first stage of tax reform. The broadening of the personal and corporate tax bases makes lower tax rates possible. Lower rates on a broader base will bring about a fairer sharing of the tax burden and encourage productive activity by rewarding economic success. Reducing tax rates, the number of rate brackets, and the number of special incentives and converting exemptions to credits, will make the tax system fairer and more understandable and will encourage growth and economic development.

1. Personal Income Tax Changes

The number of rate brackets will be reduced and tax rates lowered

Personal tax rates now rise through 10 income tax brackets to a top federal rate of 34 per cent on taxable income above $63,347. Combined federal-provincial rates are about half as much again. Starting in 1988, the 10 federal tax brackets will be reduced to three and the tax rates lowered. The new structure of federal tax rates will be:

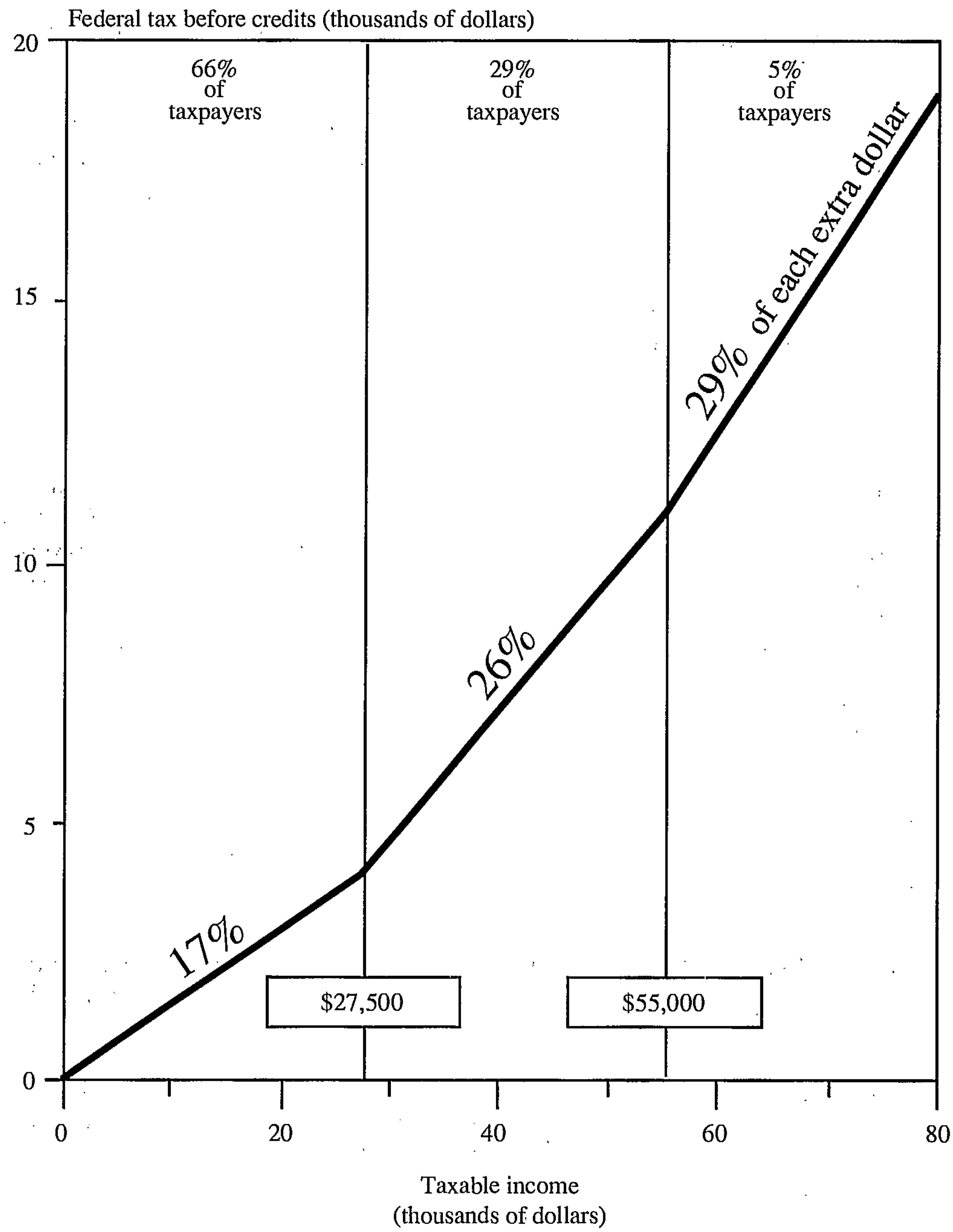
- 17 per cent on the first $27,500 of taxable income,

- 26 per cent on the next $27,500 of taxable income, and

- 29 per cent on taxable income in excess of $55,000.

Chart 4.1

New Federal Rate Structure for Individuals



Source: "Income Tax Reform", Chart 3.1, p. 18.

The lower rates will allow individual Canadians to keep more of each additional dollar earned. About 850,000 lower-income taxpayers, most of whom now face marginal tax rates of 6 per cent and 16 per cent, will no longer pay federal income tax. About 66 per cent of taxpayers will be in the lowest bracket, 29 per cent will be in the 26-per-cent bracket, and 5 per cent in the 29-per-cent bracket (Chart 4.1).

Other changes to the income tax structure, including the conversion of exemptions and some deductions to tax credits, mean that taxable income as defined under the pre-reform system does not compare directly with taxable income under the reformed tax structure.

The impact of all the changes together will be to reinforce the progressivity of the personal income tax, notwithstanding the reduction in the number of tax rates (Table 4.1).

Table 4.1

Share of Federal Income Taxes Paid by Individuals, by Income Group, 1988

Income range	Share of taxfilers	Share of federal tax payable: Before tax reform	Share of federal tax payable: After tax reform
($000)		(per cent)	
Under 15	46.7[1]	1.6	1.3
15-30	28.7	25.2	24.0
30-50	18.2	38.3	38.5
50-100	5.5	22.8	23.8
100 and over	0.8	12.1	12.4
Total	100.0	100.0	100.0

Source: "Income Tax Reform", Table 4.4, p. 37.

[1] This includes a large number of individuals who are non-taxable but file income tax returns to receive refundable tax credits or refunds of tax withheld at source. Thus, many taxfilers in this group are in a zero or net refund tax position.

Since tax rates and the number of tax brackets will be reduced, and since the difference between the highest and lowest marginal rates will be reduced to 12 percentage points, taxpayers with incomes that fluctuate widely from year to year will not pay significantly different taxes over time than persons with more stable income patterns. For these reasons, the forward averaging and block averaging provisions are not as necessary in the reformed system and it is proposed to eliminate them to simplify the tax system.

The 3-per-cent surtax will be removed when the new sales tax is implemented.

Personal exemptions will be converted to tax credits

The current tax system recognizes the particular situations of individual taxpayers by providing, in addition to the basic personal exemption, exemptions for spouses, dependent children, infirm dependants and senior citizens, as well as a special deduction for the disabled. The projected dollar amounts of these exemptions for 1988 are set out in Table 4.2.

Exemptions are currently subtracted from income before computing tax. The tax savings from exemptions therefore depend on the taxpayer's tax bracket, increasing with higher incomes. For example, under the existing system, each $1,000 of exemption is worth $60 of federal tax saving to a person in the lowest tax bracket and $340 to a person in the highest tax bracket, excluding the surtaxes.

It is fairer to provide the same tax saving to all taxpayers in identical situations, regardless of their income. This will be accomplished by converting the personal exemptions and the disability deduction to tax credits. Those credits will be subtracted directly from tax owing rather than from income. The values of the credits proposed for the 1988 tax year are also shown in Table 4.2.

The amounts included in this table refer to the *federal* values of these credits only. With the exception of Quebec, all provinces and the territories compute their personal income tax payable as a percentage of basic federal tax. In these jurisdictions, the value of the credits will be higher, reflecting the tax rates applicable in those jurisdictions.

For individuals with taxable incomes less than $27,500, the basic federal personal credit of $1,020 represents a very substantial increase over $725 – the tax value of the $4,270 exemption at a federal rate of 17 per cent. It is somewhat lower than the tax savings from an exemption for persons in the new 26-per-cent and 29-per-cent brackets and considerably lower than the $1,450 tax savings of the existing exemption to someone in the top 34-per-cent tax bracket under the pre-reform system. The conversion of this exemption to a credit thus contributes significantly to increasing the progressivity of the personal income tax system.

The increase in the basic personal credit contributes significantly to reducing taxes for lower-income taxpayers and is the major reason why about 850,000 individuals will no longer pay federal income tax. The credit enhancement also is important in offsetting the impact on lower-income taxpayers of the removal of the investment income and general employment expense deductions.

The married exemption will also be replaced by a credit. This credit of $850 will be worth considerably more than the $635 tax savings from the existing exemption to taxpayers in the 17-per-cent bracket. Under the existing system, when a spouse who has been claimed as a dependant for tax purposes enters the labour force, the first $4,270 of income earned would have been effectively taxed at the higher

Table 4.2

Effects of Conversion of Personal Exemptions to Credits

Exemptions	Estimated amount of exemption in 1988	Federal tax value of exemption[1] for taxpayer with taxable income of $20,000	Federal tax value of exemption[1] for taxpayer with taxable income of $100,000	Federal tax value of proposed federal tax credit[2]
		(dollars)		
Basic	4,270	725	1,240	1,020
Married	3,740	635	1,085	850
Equivalent-to-married for				
Dependants under 18 and other eligible dependants aged 18 or over[3]	3,740	635	1,085	850
Dependants				
Children and other dependants under 18	388[4]	65	115	65
Infirm dependants aged 18 and over	1,470	250	425	250
Other dependants 18 and over	1,000	170	290	NIL
Age 65 and over (transferable)	2,670	455	775	550
Disability (transferable)	2,920	495	845	550

(1) Federal tax savings from exemptions are calculated under post-reform rate structures as the amount of the exemption times the marginal tax rate applicable, excluding surtaxes, to individuals with incomes of $20,000 and $100,000 who claim standard deductions.

(2) The tax credits and rate brackets will be indexed to the annual increase in the consumer price index in excess of 3 per cent starting for the 1989 taxation year.

(3) Eligible dependants will be either dependants under age 18 related to the taxpayer, or the taxpayer's parents or grandparents, or any other person who is related to the taxpayer and who is infirm.

(4) Under the current law, the value of the exemption for dependants under 18 will become equal to the family allowance payment in 1989. The new credit has been set at a level equal to 17 per cent of the estimated family allowance payable in 1988. The amount in the table is the estimated 1988 value of family allowances.

Source: "Income Tax Reform", p. 71.

marginal rate of the supporting spouse. With the conversion of the married exemption to a credit, this disincentive to enter the workforce is eliminated.

A credit of $850 will also replace the current equivalent-to-married exemption but the credit will only be claimable in respect of a parent or grandparent of the taxpayer, a person related to the taxpayer who is infirm, or a dependant under 18 years of age. This latter restriction is consistent with the removal of the exemption for dependent children 18 years of age and over, and reflects the fact that the age of majority is now 18.

The exemption for infirm dependants will be converted to a credit of $250, approximately equal to the tax value of the current exemption for individuals in the 17-per-cent bracket.

The exemption for dependent children under age 18 will be converted to a credit of $65, an amount that represents 17 per cent of the estimated value of the family allowance payment in 1988. This means that family allowance payments will effectively be free of tax for individuals with taxable income up to $27,500. It is not proposed to change the level of the existing refundable child tax credit. As the appropriate tax treatment of child care expenses will be examined in the context of child care policy, no change in the current child care deduction is proposed at this time.

The age exemption will be converted to a credit of $550. This amount represents a significant enhancement over the tax savings of $455 that the existing exemption would provide for the vast majority of senior citizens in the new 17-per-cent tax bracket. This credit will be transferable to the taxpayer's spouse to the extent that the taxpayer cannot use it. The conversion of this deduction to a credit at an enhanced value for lower-income taxpayers ensures that tax benefits are targeted to those elderly taxpayers most in need. This helps account for the fact that nine in ten elderly households affected will see their taxes reduced as a result of tax reform.

The disability deduction will also be converted to a credit of $550. The broadened definition of disability introduced for 1986 will continue to apply and the credit will be transferable to the taxpayer's spouse, supporting parent or grandparent, to the extent that the taxpayer cannot use it.

The conversion of the personal exemptions to credits is a major step in improving the fairness of the tax system. Credits make the tax system more understandable. Converting exemptions to tax credits directs more resources to those in need and reduces the after-tax value of benefits to higher-income Canadians. Greater use of tax credits provides a major building block which can be used in the future to improve and better target assistance to Canadians in need.

Other Deductions Converted to Tax Credits

A number of other existing deductions will be converted to tax credits at a rate of 17 per cent. These are listed in Table 4.3. Converting these deductions to credits at

17 per cent will have no impact on taxpayers whose taxable income is below \$27,500, since their tax rate is 17 per cent. It will, however, reduce the tax savings of the deductions for individuals with taxable income greater than \$27,500. It will thus broaden the tax base and increase the fairness of the personal income tax.

Pension Income Deduction: Currently, the first \$1,000 of eligible pension income is deductible in computing taxable income. The targeting of this relief to lower-income pensioners will be improved through the conversion of the existing deduction to a credit at 17 per cent for up to \$1,000 of eligible pension income. The maximum credit will thus be \$170. It will be transferable to a spouse, to the extent the taxpayer cannot use it.

Tuition Fees and Education Deductions: A new tax credit at the rate of 17 per cent will replace the existing deduction for post-secondary tuition fees, and a credit of \$10 per month will replace the \$50 per month education deduction. Students will be able to claim a credit of 17 per cent of post-secondary tuition fees paid without limit. Often, however, students will owe insufficient tax to make full use of the credit. Under the current system, such unused tuition deductions are not transferable. A new and important feature will allow the transfer of the unused portion of the first \$600 of education and tuition credits to a supporting spouse, parent or grandparent.

Medical Expense Deduction: Uninsured medical expenses are currently deductible in computing taxable income to the extent that they exceed 3 per cent of net income. This deduction will also be converted to a credit at 17 per cent to give equal tax recognition of this expense to all taxpayers regardless of their income.

Charitable Donations: Taxpayers may currently claim a deduction for charitable contributions. This deduction will be converted to a two-tier credit of 17 per cent of annual contributions up to \$250 and 29 per cent for the portion of contributions over \$250. This will maintain a substantial incentive for charitable giving. At the same time it will increase fairness by basing tax assistance on the amount given, regardless of the income level of the donor.

Contributions to the Canada and Quebec Pension Plans (CPP/QPP) and Unemployment Insurance (UI) Premiums: These social insurance payments are currently deductible in computing net income, with the result that the net after-tax contribution is much lower for a high-income individual than for a person with lower earnings. To achieve greater fairness, it is proposed that the deduction be converted to a credit equal to 17 per cent of CPP/QPP contributions and UI premiums paid by employees. The employer portion of these payments will continue to be treated as a business expense and thus remain deductible as are other business expenses.

Refundable Sales Tax Credit

As part of the first stage of tax reform, the refundable income-tested sales tax credit will be increased, starting in 1988. The credit is now \$50 per adult and \$25 per child under age 18, paid in full up to \$15,000 of family net income and

Table 4.3

Other Deductions Converted to Credits

Deduction	Current treatment	Proposed federal credit
Pension income	Eligible pension income deductible up to $1,000. Unused deduction transferable to spouse.	17% of eligible pension income, maximum $170. Unused credit transferable to spouse.
Tuition fees	Deductible by student; not transferable.	17% credit for post-secondary fees; up to $600 transferable to spouse or supporting parent or grandparent.
Education	$50 per month deduction for each month in full-time attendance; transferable.	$10 credit per month for each month in full attendance; transferable within $600 limit for tuition.
Medical expenses	Deduction for uninsured medical expenses in excess of 3% of net income.	Credit of 17% for uninsured medical expenses in excess of 3% of net income.
Charitable contributions	Fully deductible up to 20% of net income.	Credit at 17% for first $250 per year; 29% credit for remainder of contributions up to 20% of net income.
CPP/QPP and UI premiums (employee share)	Deductible	Credit at 17%.

Source: "Income Tax Reform", Chapter 5, pp. 72-78.

reduced by 5 per cent of family net income above that threshold. This credit will be increased by $20 for each adult and $10 per child and will be reduced by 5 per cent of family net income above $16,000.

A number of deductions will be reduced or removed

The combination of the new rate structure and the conversion of deductions and exemptions to tax credits does much to enhance the basic fairness and understandability of the personal income tax system.

To help provide the necessary resources to finance the substantial rate reductions described above, the base must be broadened. This is being accomplished in a way which will result in individuals in similar economic circumstances being treated more equitably.

Capital Gains: The lifetime exemption for capital gains for individuals plays an important role in providing a general, broad-based incentive for risk-taking entrepreneurship and the development of small businesses and productive farms. The $500,000 lifetime exemption will be maintained for capital gains on farmland. Small business shares will be eligible for the $500,000 exemption, effective in 1988. However, the proposed reduction in tax rates will provide a broad incentive to save and invest. It is therefore appropriate to limit the lifetime exemption on capital gains on other property to $100,000, the limit currently in effect for the 1987 tax year. To reduce tax shelter possibilities and better match deductions with taxable income, individuals will be able to claim a capital gains exemption only to the extent the gains exceed cumulative net investment losses after 1987.

The inclusion rate – that is, the proportion of an individual's capital gain that is taxable – will be increased from the current rate of 50 per cent to 66⅔ per cent in 1988 and to 75 per cent for 1990 and subsequent taxation years. This will increase the maximum effective federal rate of tax on capital gains in excess of the lifetime exemption from 17 per cent currently to about 19 per cent in 1988 and 22 per cent in 1990.

Dividend Tax Credit: The dividend tax credit will be reduced to reflect the reduction in corporate tax rates and to maintain the current degree of integration between the personal and corporate tax systems. The combined federal/provincial credit will be reduced from 33⅓ per cent to 25 per cent of cash dividends received from taxable Canadian corporations. Consequential changes will be made to the mechanisms that integrate the tax on private corporations and their shareholders.

Interest and Dividend Income Deduction: This provision, which permits a deduction of up to $1,000 of interest and dividend income, was introduced at a time of high inflation and high personal tax rates as an approximate method of providing some allowance for tax paid on the inflation component of interest and dividends. This deduction will be removed starting in 1988. The increase in the basic personal credit more than offsets the impact of this change for lower-income Canadians, including many elderly.

Treatment of Retirement Savings: To encourage individuals to provide for their own retirement, the changes in the structure of the tax treatment of registered pension plan (RPP) and registered retirement savings plan (RRSP) contributions announced on October 9, 1986 will be maintained. These changes provide more equal access to tax assistance among individuals who save through different types of arrangements. They also provide individuals with needed flexibility to spread their retirement saving over time without losing tax assistance.

The phase-in of the new RRSP and RPP limits will be slowed down to contribute to tax base broadening. The implementation of the new system will be postponed for one year and the increases in the dollar limits phased in more slowly so that the maximum limit of $15,500 is reached in 1994 (instead of 1990) for money-purchase employer-sponsored plans and in 1995 (instead of 1991) for RRSPs.

In subsequent years the limit of $15,500 will be indexed to changes in the yearly maximum pensionable earnings for the Canada Pension Plan.

The effect of these changes is that, when fully phased in, full tax assistance will be available on pensionable earnings up to 2½ times the average industrial wage, compared to the level of three times the average industrial wage that would have been reached in 1990 under the changes announced last fall.

Automobile Expenses: There will continue to be full tax write-offs for automobiles which are used all or substantially all for business purposes. However, only the first $20,000 of the cost of any automobile will be eligible for capital cost allowance, and related limitations will apply to deductions for lease costs and financing charges.

To better match tax deductions with the additional cost incurred when a personal automobile is not used all or substantially all for business purposes, the amount deductible in respect of capital cost allowance and financing costs will be reduced, and only the incremental cost of commercial insurance and licence charges will be deductible.

Meal and Entertainment Expenses: Deductions for meal and entertainment expenses will be limited to 80 per cent of their cost in recognition of the fact that these expenditures confer some personal benefit on the recipient.

Home Office Expenses: Deductions for expenses of maintaining a home office will be limited to a home office that is the principal place of business of the taxpayer or is used on a regular basis for meeting clients, customers or patients. Expenses will be claimable only up to the income from that business.

Employment Expenses: Because the basic personal credit has been substantially enhanced, the $500 employment expense deduction will be eliminated.

Employed musicians will be allowed to claim capital cost allowance on musical instruments they are required to provide as part of their contract of employment, up to the income from that employment.

Other Deductions: The capital cost allowance (CCA) rate on certified Canadian film productions will be reduced from 100 per cent to 30 per cent. However, investors will be able to deduct the cost of a film fully, and without the half-year rule applying, to the extent of their income from all films in a year. These changes maintain a tax regime supportive of the Canadian film industry while reducing the opportunity for sheltering other income from tax.

The special CCA provisions applicable to multiple unit residential buildings (MURBs) will not be available for acquisitions after June 17, 1987 and will be terminated after the 1990 taxation year for properties already held by the taxpayer.

Tax Treatment of Farmers: Changes are proposed in the tax treatment of farm income. These changes will not affect the tax position of full-time farmers with positive farm income measured on a cash basis.

First, farm losses deductible against non-farm sources of income will be reduced to the amount of loss computed on a simplified accrual basis. This change is designed to prevent tax avoidance by individuals with high incomes from sources other than farming. For farms in a loss position, the new rules ensure that the losses for tax purposes more closely approximate the economic loss incurred by the taxpayer.

The second change proposes clear, easily understood criteria for determining whether, and to what extent, farm losses will be deductible against other sources of income. The new rules will permit the full deduction of farm losses (measured on a simplified accrual basis) against other income if an individual's gross farm sales have exceeded net income from all other sources in at least three of the seven most recent years, including the current year. If this test is not met, up to $15,000 of loss may be deducted in the current year with the remainder carried forward to future years. This is a substantial increase from the $5,000 limit on restricted farm losses that now applies.

The third change will provide clearer criteria for distinguishing between hobby farms and those farms with a reasonable expectation of profit.

The new rules provide objective guidelines for farmers to meet in order to achieve full-time farmer status for tax purposes. They ensure that most farmers who are in a loss position will know, when they file their returns, whether all, or part, of their farm losses will be deductible against other sources of income.

New rules for start-up farms will recognize the special needs of beginning farmers.

These changes, and the relevant transition rules, are described in detail in Chapter 5 of "Income Tax Reform".

The proposed tax treatment of farm income contrasts sharply with the existing subjective rules applied to determine whether a farm is a business and, if so, whether it is a full-time or a part-time business entitled only to limited loss deductions. The existing rules are difficult both to comply with and administer. The tax reform proposals improve the existing system while preserving the benefit of cash accounting for tax purposes for farmers with positive farm income.

2. Impacts on Individuals and Households

These changes to the personal income tax system accomplish three major objectives.

- They reduce tax liabilities for 8.9 million households.
- They relieve about 850,000 lower-income Canadians from having to pay federal tax.

- They reduce variation in the tax treatment of individuals in similar economic circumstances.

They will reduce federal personal income taxes by $11 billion over the next five years.

Table 4.4 summarizes the overall effects of tax reform on Canadian households.[3]

Table 4.4

Overall Impact of Tax Reform on Households

Average Change in Federal/Provincial Personal Income Tax
Due to Tax Reform Measures, 1988

Income range	Households: Number affected	Households: Average change	Change as a per cent of tax	Change as a per cent of income
($000)	(000)	($)	(%)	(%)
Under 15	2,860	−90	−15.5	−0.8
15-30	3,310	−320	−10.2	−1.4
30-50	2,575	−310	−4.1	−0.8
50-100	1,740	−395	−2.6	−0.6
100 and over	235	−1,615	−3.2	−1.0
Total	10,720	−295	−4.5	−0.9

Source: "Income Tax Reform", Table 4.2, p. 33.

Personal income tax reform lowers taxes across all income ranges. The average federal/provincial tax saving is $295 per household affected. While tax savings increase in dollar terms as incomes rise, savings in the lower- and middle-income groups represent a larger percentage reduction in tax than for upper-income ranges.

For 8.9 million households – over 80 per cent of the total – tax reform will mean reduced income taxes. The average tax cut per household with reduced taxes is about $475. For these Canadians, the gains from tax rate reductions and the conversion of personal exemptions into tax credits far outweigh the reductions in tax preferences. Below $15,000 of income, almost nine out of every ten affected households will pay less tax.

[3] For an analysis of the impact of tax reform on various types of individual taxfilers and households, see "Income Tax Reform" pp. 51-65.

Table 4.5 contrasts the number of households experiencing a reduction in tax as a result of tax reform with those who see their taxes increase. About 1.5 million households will see their personal income taxes increase – on average by $665. Limits on the use of the lifetime capital gains exemption, cutbacks in tax shelters, and reductions in the dividend tax credit are the major causes of the increase for higher-income taxpayers. Taxes do rise for a small proportion of households with incomes less than $15,000. Persons in this income range whose taxes increase are

Table 4.5

Impact of Tax Reform
Average Change in Federal/Provincial Personal Income Tax, 1988

Households With A Decrease In Tax

Income range	Number affected	Average change	Change as a per cent of tax	Change as a per cent of income
($000)	(000)	($)	(%)	(%)
Under 15	2,315	–140	–19.9	–1.4
15-30	2,910	–405	–12.4	–1.8
30-50	2,090	–470	–6.2	–1.2
50-100	1,360	–700	–4.4	–1.1
100 and over	175	–4,365	–7.8	–2.6
Total	8,850	–475	–7.2	–1.5

Households With An Increase In Tax

Income range	Number affected	Average change	Change as a per cent of tax	Change as a per cent of income
($000)	(000)	($)	(%)	(%)
Under 15	335	180	25.1	1.7
15-30	335	380	18.6	1.7
30-50	440	430	6.4	1.1
50-100	355	745	5.7	1.2
100 and over	65	6,140	16.9	3.6
Total	1,530	665	9.5	1.6

Source: "Income Tax Reform", Table 4.3, p. 36.

those who have a substantial portion of their gross income derived from investment or self-employment and who therefore are affected by measures such as the new limits on deductions for automobiles, home offices and entertainment costs and such other measures as the lower dividend tax credit. Those whose primary source of income is wage or pension income will generally not find their taxes increased.

Tax reform reinforces the progressivity of our tax system. As indicated in Table 4.1, the share of federal income tax paid by taxpayers in income groups above $50,000 increases, while the share paid by those below $30,000 falls. While all income groups have reduced tax in total as a result of personal income tax reform, lower- and middle-income Canadians experience the greatest percentage reduction in their tax.

Reducing Taxes for the Elderly

There are 1.4 million households with at least one individual aged 65 and over in Canada. Table 4.6 illustrates the substantial benefit of tax reform for this group. In fact, fully 1.2 million of these households will see their taxes cut as a result of tax reform. While the removal of the $1,000 investment income deduction and the lower dividend tax credit will affect elderly Canadians, the impact of these changes will be more than offset by the new basic personal credit, the age credit and pension income credit. These measures are designed to ensure that tax assistance is targeted more fairly to those who need it most.

Table 4.6

Overall Impact on Households Age 65 and Over:
Change in Federal/Provincial Personal Income Tax, 1988

Income range	Number affected	Average change	Change as a per cent of tax	Change as a per cent of income
($000)	(000)	($)	(%)	(%)
Under 15	405	–160	–35.4	–0.9
15-30	605	–350	–16.6	–1.6
30-50	265	–265	–4.4	–0.7
50-100	115	–165	–1.2	–0.2
100 and over	35	–1,465	–2.6	–0.8
Total	1,425	–290	–6.3	–0.9

Source: "Income Tax Reform", Table 4.5, p. 38.

Reducing Variation in Taxes Paid by Persons in Similar Economic Circumstances

A key goal of tax reform is to narrow the variation in tax paid by persons in similar economic circumstances. A number of changes will reduce the tax preferences that now benefit only certain individuals, while lower rates and the conversion of exemptions to credits will provide more benefits to taxpayers generally.

There is considerable variation in the impact of tax reform within income ranges. Individuals who had used relatively few special tax preferences and had paid above-average tax will find their tax reduced, often significantly. Those with tax increases had generally paid below-average amounts, often well below average.

Table 4.7 shows how tax reform will narrow the gap between households within an income group. It illustrates the difference in average tax rates between those whose tax is reduced and those whose taxes increase as a result of tax reform. Prior to tax reform the average tax rate was considerably higher for those whose tax is reduced than for those whose tax rate is increased, reflecting the significant

Table 4.7

Narrowing Variations in Average Federal/Provincial Income Tax Rates, 1988

	All households with a decrease in tax		All households with an increase in tax	
Income range	Average federal/provincial tax rate before reform	Average federal/provincial tax rate after reform	Average federal/provincial tax rate before reform	Average federal/provincial tax rate after reform
($000)	(per cent)			
Under 15[1]	7.1	5.7	6.9	8.6
15-30	14.7	12.9	9.3	11.0
30-50	19.7	18.5	16.6	17.7
50-100	24.3	23.3	20.1	21.2
100 and over	33.8	31.1	21.5	23.2
Total	20.5	19.0	17.3	18.6

[1] The tax rate for these two groups is not strictly comparable before and after tax reform because of the wide variety of circumstances of persons in this group. After tax reform, households paying higher taxes include persons with net income under $15,000 due to deducting expenses for automobiles, home offices and entertainment expenses. These persons are affected by the new rules restricting deductions for these expenses. Some have significant investment income and their taxes are changed by such measures as the reduction in the dividend tax credit.

Source: "Income Tax Reform", Table 4.6, p. 39.

Table 4.8

Overall Impact of Tax Reform on Individual Taxfilers by Income Source

Principal source of income	Number of taxfilers affected	Average federal/provincial tax as a per cent of income		Change in tax due to tax reform		
		Before reform	After reform	Average change	Change as a per cent of tax	Change as a per cent of income
	(000)	(%)	(%)	($)	(%)	(%)
Wage or salary	10,055	20.1	19.0	−285	−5.2	−1.1
Other	2,083	15.4	15.6	65	1.7	0.3

Source: "Income Tax Reform", Table 4.7, p. 41.

variation in tax at a given income level as a result of various tax preferences within the existing system. The average tax rates of the two groups generally move closer as a result of the tax reform proposals. But, after reform, the tax paid by those with an increase in tax generally remains below average.

Effectively, while variations in tax within an income group will be narrowed, they are not eliminated. This is because the tax reform proposals leave in place incentives and special tax treatment to promote important social and economic priorities.

Impact on Persons with Different Sources of Income

Table 4.8 shows that tax reform has different effects on individual taxfilers with different principal sources of income because of the different uses these taxfilers make of various preferences. Those whose income is derived mostly from salary and wages will have a tax reduction. Those whose main income is derived from investments or self-employment have tax increases on average. While investment income will be taxed at higher rates relative to wage and salary income than before, dividends and capital gains will still receive preferential tax treatment.

Fewer Lower-Income Canadians Paying Income Tax

Tax reform will relieve about 850,000 lower-income individuals from paying federal income tax because the basic personal credits significantly raise the income thresholds at which individuals begin to pay tax. Table 4.9 shows how much the income thresholds will be raised in 1988 for representative taxfilers – up 12 per cent for an elderly married couple and 26 per cent for an individual under age 65.

Table 4.9

Income Threshold at Which Individuals Start Paying Federal Tax, 1988

	Before tax reform	After tax reform
	($)	($)
Single individual under 65	4,940	6,220
Married one-earner couple under 65 with two children	16,770	18,470
Single individual aged 65 and over	10,785	11,430
Married couple aged 65 and over	16,945	19,010

Note: For taxfilers under age 65, it is assumed that income represents wage income. Standard deductions such as the employment expense deduction, CPP/QPP and UI contributions have been taken into account in computing taxes. Family allowances are also included in income for taxfilers, where appropriate. For taxfilers aged 65 and over, income represents a combination of OAS, pension and investment income.

Source: "Income Tax Reform", p. 41.

Regional Balance

All regions of the country share in the benefits of personal income tax reform. Table 4.10 indicates that in every province, those who benefit from tax reform far outnumber those who will face tax increases. Consistent with the commitment to greater tax fairness, less economically advantaged regions gain more. Federal personal income tax revenues decline further in these areas than in other regions.

In addition, in the Atlantic region, the ratio of those with a decrease in tax to those with an increase is the largest in the country.

3. Corporate Income Tax Changes

The first stage of tax reform will also introduce significant changes to the corporate income tax. The corporate changes will be phased in over the period 1988 to 1991.

These changes are designed to:

- reduce corporate tax rates to encourage economically sound investments and to ensure our corporate tax system remains internationally competitive;

Table 4.10

Regional Impact of Federal Personal Income Tax Changes

	Individual taxfilers becoming non-taxable		Individual taxfilers with tax: decrease	Individual taxfilers with tax: increase	Change in total federal tax collections
	(000)	(%)	(000)	(000)	(%)
Newfoundland	25	10.6	190	30	−6.3
Prince Edward Island	6	10.0	50	8	−5.5
Nova Scotia	30	7.1	355	55	−5.6
New Brunswick	25	6.4	280	45	−5.8
Quebec	210	6.3	2,690	510	−4.6
Ontario	295	5.6	4,160	825	−4.2
Manitoba	50	8.5	460	95	−4.8
Saskatchewan	30	6.0	390	90	−3.6
Alberta	70	5.4	1,040	210	−4.2
British Columbia	95	6.1	1,280	235	−4.5
All Canada(1)	843	6.1	10,960	2,120	−4.4

(1) All Canada total includes residents of the Yukon and Northwest Territories, taxpayers living outside Canada and those subject to tax in more than one jurisdiction. Because of small sample sizes, separate estimates are not shown for individuals in these categories.

- broaden the tax base, reduce the disparity in effective tax rates among industries, and ensure more profitable corporations pay tax by reducing selective tax preferences;
- reduce the mismatch between the timing of tax deductions and actual economic costs, which gives rise to a deferral in tax; and
- curb artificial tax avoidance.

The tax reform proposals will increase federal corporate income tax revenue by $5 billion over the next five years.

These changes are consistent with those outlined in the May 1985 discussion paper and build on the changes introduced in the February 1986 budget.

Statutory Rates Will Be Reduced

Federal statutory corporate tax rates will be lowered starting July 1, 1988. The general federal rate, currently 36 per cent, will fall to 28 per cent. The tax rate for manufacturing income will be reduced from its current level of 30 per cent to

26 per cent and thereafter by 1 percentage point per year to reach 23 per cent in July 1991. The small business tax rate – applicable on the first $200,000 of income of Canadian-controlled private corporations – will be reduced to 12 per cent. The special tax rate for small manufacturers will be eliminated and as a result, the tax rate on these small businesses will also be 12 per cent. These changes are summarized in Table 4.11.

Table 4.11

Federal Corporate Income Tax Rates

	Current statutory rates	New statutory rates effective July 1 each year 1988	1989	1990	1991 and subsequent years
		(per cent)			
General business	36	28	28	28	28
Manufacturing business	30	26	25	24	23
General small business	15	12	12	12	12
Small manufacturing business	10				

Note: These changes will not affect the tax rate reductions scheduled to take effect on July 1, 1987. All the rates are after the 10-per-cent provincial abatement.

Source: "Income Tax Reform", Chapter 5, p. 98.

These reductions, when combined with a typical provincial rate of 14 per cent, will reduce the general statutory rate from its current level of 50 per cent to 42 per cent (federal plus provincial) on July 1, 1988. This rate will be about 3 percentage points higher than the comparable U.S. rate.

The 3-per-cent surtax on corporate income tax will be eliminated when the new sales tax system is implemented.

The Corporate Income Tax Base Will Be Broadened

Corporate tax base broadening makes tax rate reductions possible. Reduced corporate tax preferences will broaden the corporate tax base by about 20 per cent. As a result of reform, federal corporate tax revenues will be about 10 per cent higher after taking account of the tax rate cuts. Corporate taxes paid to provincial governments will also increase. All sectors will be affected to some extent, but much of the increase will come from reductions in depreciation write-offs and from measures that affect sectors which now pay below-average corporate tax, such as finance, insurance and real estate.

Capital Cost Allowances Will Be Modified

The basic structural elements of the capital cost allowance (CCA) system will remain in place. However, write-offs which contribute to low taxation of certain sectors are being reduced, although an incentive element will generally remain.

The three-year write-off for machinery and equipment now available will be reduced to a 25-per-cent declining balance rate. The current incentive rate will be phased down as the tax rate applicable to manufacturing is reduced. The 25-per-cent CCA rate applicable for 1991 and subsequent years will continue to provide an element of incentive and, combined with the lower tax rate, will ensure that manufacturing is not placed in a disadvantageous position internationally by the tax system.

The proposed changes to CCA rates are outlined in Table 4.12.

The new system will become effective in 1988, with appropriate grandfathering and transition provisions.

For financial statement accounting in Canada and for tax purposes in most other industrialized countries, assets may not be depreciated until they are actually put in use. Currently in Canada, assets may begin to be depreciated for tax purposes when acquired. In many cases this results in a significant mismatch of revenues and expenses that gives rise to a deferral of tax. Beginning in 1990, CCA will only be claimable commencing in the year the asset is actually put in use.

Over the next five years these changes to the CCA system will contribute approximately 27 per cent of the total corporate base broadening.

Capital Gains Inclusion Rate Will Be Increased

The proportion of capital gains to be included in a corporation's income will be increased from one-half to two-thirds in 1988 and to three-quarters in 1990. These changes will increase the effective federal tax rate on gains for corporations from the current rate of 18 per cent to 18⅔ per cent in 1988 and to 21 per cent in 1990 and subsequent years.

This provision will contribute 11 per cent to corporate base broadening over the next five years.

Regional Incentives Are Maintained

The corporate tax reform proposals recognize the importance of regional and sectoral differences in Canada's economy. The tax system will continue to operate in conjunction with other federal programs to support regional economic development. The reform measures will respect Canadian needs by continuing many traditional incentives that are important for Canada's extractive, resource-based industries.

Table 4.12

Major Changes in CCA Rates After Full Implementation

	Current CCA rate	Proposed CCA rate
Manufacturing machinery and equipment	three-year straight line [1]	25% declining balance
Manufacturing retooling	immediate write-off	subject to half-year rule
Resource extraction assets	30% declining balance (plus immediate write-off up to income from new mine)	25% declining balance (plus immediate write-off up to income from new mine)
Drillships and offshore platforms	30% declining balance	25% declining balance
Earth-moving equipment	50% declining balance	30% declining balance
Buildings	5% declining balance	4% declining balance
Satellites	40% declining balance	30% declining balance
Outdoor advertising signs	35% declining balance	20% declining balance
Certified Canadian films	100%	30% declining balance (plus immediate write-off up to film income)
Public utility property	6% declining balance	4% declining balance

(1) Taking account of the half-year rule.

Source: "Income Tax Reform", Chapter 5, p. 102.

The proposals also retain the regional tax credits now in place for investment in Atlantic Canada, Cape Breton and the Special Investment Tax Credit regions. The rate of the credits for investments after 1988 will be reduced in line with reductions in tax rates, but their relative incentive effect will be maintained. Proposed rates of investment tax credit are shown in Table 4.13.

R&D Incentives Are Retained

The tax credit and write-offs for R&D costs, with the exception of buildings claimed for R&D, will be retained at current levels. Specialized R&D structures (such as wind tunnels or experimental energy prototypes), as well as machinery

Table 4.13

Proposed Investment Tax Credit Rates, 1987-1989

	1987	1988	1989
	(per cent of eligible investment)		
Current 5-per-cent rate[1]	5	3	0
Current 7-per-cent rate[1]	7	3	0
Special regional rate for manufacturing in specified areas	40	40	30
Research and development	unchanged from current rates of 20, 30 and 35 depending on location and size of firm		
Atlantic region	20	20	15
Cape Breton	60	60	45
High-cost exploration	unchanged from current rate of 25		

[1] The phase-out of general rates of ITC as announced in February 26, 1986 budget.

Source: "Income Tax Reform", Chapter 5, p. 110.

and equipment used for R&D, will continue to qualify for the existing R&D incentives. The return on R&D investments will be increased through corporate tax rate cuts.

Firms carrying out R&D activities in Canada will thus continue to benefit from one of the most favourable tax regimes for research and development in the industrialized world.

Other ITC Changes Are Made

The amount of the investment tax credit that can be used to reduce a taxpayer's federal tax will be limited. With the exception of tax payable on income qualifying for the small business deduction, only one-half of a taxpayer's federal tax payable in any year will be able to be offset by the ITC. The carry-forward period will be extended from seven to ten years.

Changes are also proposed to the refundability provisions for ITCs.

Tax Treatment of the Extractive Resource Sector is Modified

The resource sector as a whole will benefit from the reduced corporate tax rate and most of the incentives which apply to this sector will be retained.

The ability to attract outside capital to the mining and petroleum sectors through the use of flow-through shares will be retained. Changes will be made to the limited partnership and flow-through share regimes for these sectors to ensure the appropriate use of these incentives.

For the oil and gas sector, the reduced rates of tax will more than offset the base broadening measures which apply to this sector. Taxes paid by this sector will decline.

In addition to having access to flow-through share financing, mining has a number of incentives including earned depletion, accelerated CCA, immediate deduction for all pre-production expenses, a resource allowance which generally exceeds provincial royalties, and the 100-per-cent write-off on class 28 assets – resource extraction property – to the extent of income from a new mine or major expansion. These incentives will be retained, with one exception.

Earned depletion, which provides for the generation of tax deductions that exceed amounts actually spent for certain exploration and resource development expenditures, will be phased out. The rate at which depletion can be earned will be reduced from 33⅓ per cent to 16⅔ per cent of eligible expenditures on July 1, 1988, and eliminated as of July 1, 1989. The phase-out of the 33⅓-per-cent depletion provision will apply to tar sands and enhanced oil recovery investments.

It is intended that the Canadian Exploration and Development Incentive Program, which provides temporary assistance for exploration and development costs in the petroleum industry, will be phased out over approximately the same time period as earned depletion.

Major projects with long lead times are high risk given the volatile and uncertain nature of the world oil market. Accordingly, as in the past, the government will consider what adjustments in non-tax assistance would be appropriate to encourage major oil and gas projects which provide important regional or national benefits and are fundamentally economic. Enhanced oil recovery by tertiary techniques also experiences higher costs and greater risks than the conventional industry. The government will consider what new forms of assistance might be required by such activity in light of industry economics and our future energy needs.

Special Tax Provisions Available for Finance, Insurance and Real Estate Companies Will Be Revised

In conjunction with changes of general application, other tax reform proposals will affect the real estate, finance and insurance sectors. The measures proposed will ensure that profitable firms in these industries, which have typically been low-tax industries, will carry a more appropriate share of the corporate tax burden. Seventy-four per cent of financial statement income for profitable firms in this sector will become subject to tax, compared to 49 per cent currently, and the average federal rate of tax on profitable companies will increase from 14½ per cent to over 21 per cent of income reported on financial statements.

Many life insurance companies now pay negligible amounts of tax. Some of the changes proposed will correct what are generally accepted as anomalies in the existing rules. For example, deductions for certain reserves will be reduced and a more accurate definition will apply to separate taxable Canadian income from tax-exempt foreign income for multinational insurers. Another measure gradually reimposes the tax on insurance companies' investment income that was dropped in 1978.

The reform proposals will reduce the deductions now allowed to financial institutions for doubtful debt reserves. Tax treatment of reserves for all types of financial institutions will be comparable. The tax treatment of bank reserves will no longer be directly linked to the prudential requirements for reserves.

These measures, applicable to the finance and insurance industries, will contribute 28 per cent of the total corporate tax base broadening over the next five years.

Real estate companies and other land developers will be required to capitalize costs of carrying vacant land for development and unused land held in the course of a business, and to capitalize construction period "soft costs", as is now generally required for financial accounting purposes and as is applied to other taxpayers.

Other changes will require that expenses of issuing stocks, bonds and other securities be written off over several years rather than immediately, bringing tax rules more into line with accounting principles and practice.

Deductions for Meals and Entertainment Expenses Will Be Limited

Deductions for meals and entertainment expenses will be limited, for all corporations, to 80 per cent of the amounts actually incurred. This parallels the limitation for the self-employed.

Tax-Motivation for Preferred Share Financing Will Be Removed

It is proposed to reduce the tax advantage for non-taxpaying companies of financing through the use of preferred shares.

Based on the principle of integration, the Canadian income tax system provides relief from taxation for dividends received by corporations (through the inter-corporate dividend deduction) and by individuals (through the dividend tax credit). This recognizes that the dividends are generally paid out of income that has already been subject to tax. However, the accelerated deductions and tax credits provided in the Canadian tax system over the last decade have resulted in many profitable corporations not paying tax, although they were in a position to pay dividends. In such situations a corporation may use preferred share financing and thus take advantage of the tax relief provided to the dividend recipient even though no tax has been paid on the underlying income.

The objective is to remove the tax motivation from preferred share financing. However, the government recognizes that there are important non-tax reasons for issuing preferred shares, and the mechanism being introduced has been designed to avoid interfering with the use of preferred shares for ordinary corporate finance reasons.

The mechanism to be employed, which will apply to new issues of preferred shares, will have the effect of taxing dividends on preferred shares if the earnings of the payor corporation are non-taxable. The tax is designed to:

- allow taxpaying corporations to raise preferred share capital;
- exempt smaller corporations and investment vehicles; and
- recognize private investment arrangements where preferred shares are used to take into account different rights and interests of investors.

This initiative makes an important contribution to corporate base broadening and the effort to ensure that profitable corporations pay tax.

4. Impacts on Corporations

Increasing Corporate Income Tax Share of Current Revenues

Tax reform will result in corporations making a significantly higher contribution to the total tax revenues collected by the federal government. As shown in Chart 4.2, the share of corporate tax revenues will rise from 15.6 per cent currently to 17.2 per cent by 1992. Federal revenues will increase by $470 million in 1988, and the increase will grow to about $1.6 billion in 1992, as the measures are fully phased in. Over the period, corporate taxes will increase by over $5 billion in total. These increases in corporate taxation will help to fund the personal income tax rate reductions.

Corporate Base Broadening to Fund Tax Rate Cuts

Substantial corporate tax base broadening allows a significant reduction in corporate tax rates, while at the same time helping to fund personal tax rate cuts. Over all, the percentage of financial statement income for profitable firms that is subject to tax will increase from its current level of 72 per cent to over 84 per cent.

All sectors of the economy contribute to base broadening. Table 4.14 shows the relative impact of base broadening by sector. The base broadening is concentrated in sectors that now have relatively low proportions of their income subject to tax and relatively more profitable firms that do not pay tax.

Chart 4.2

Share of Corporate Tax In Total Federal Tax Revenues

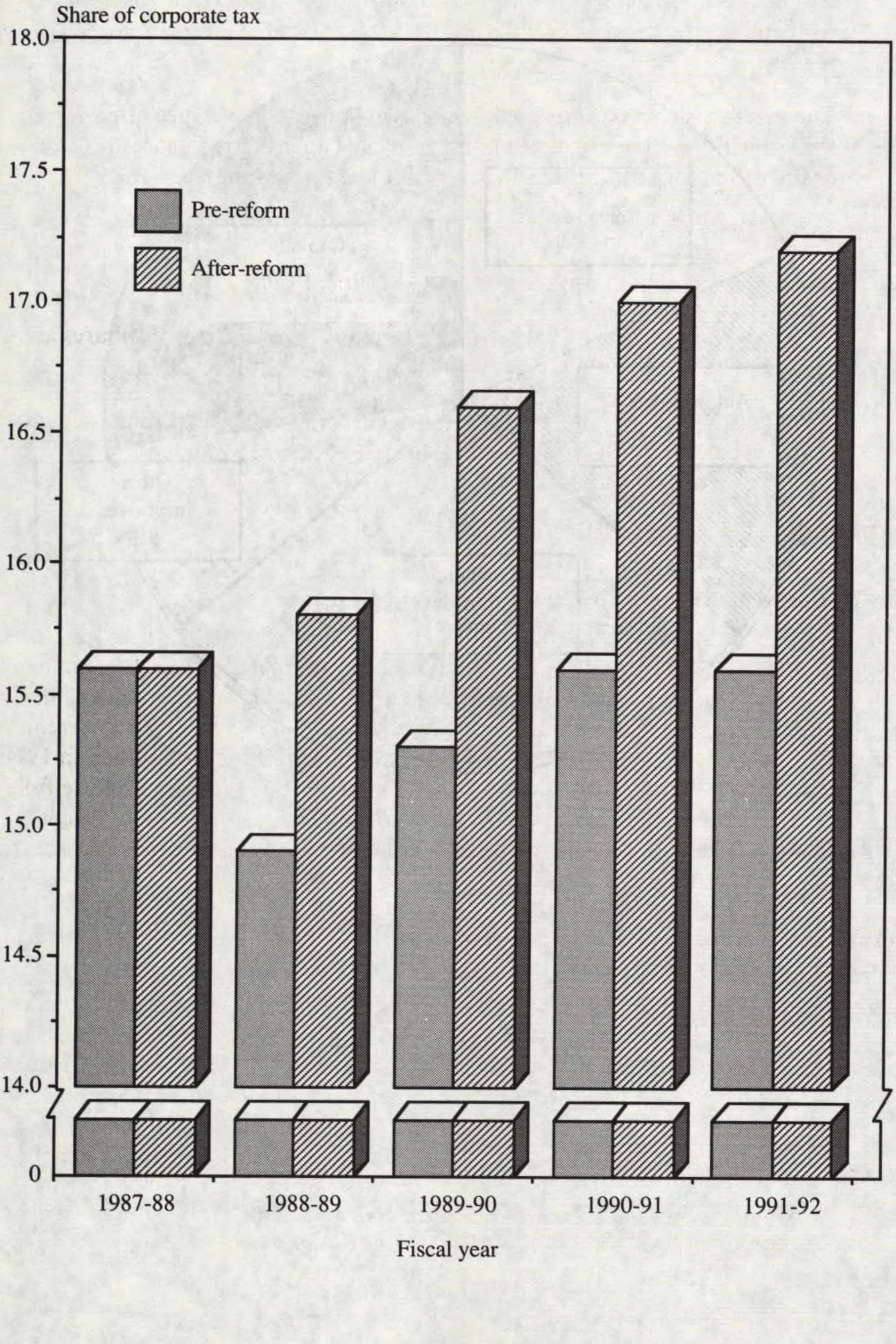


Chart 4.3

How Base-Broadening Measures, 1988-1992 Are Distributed

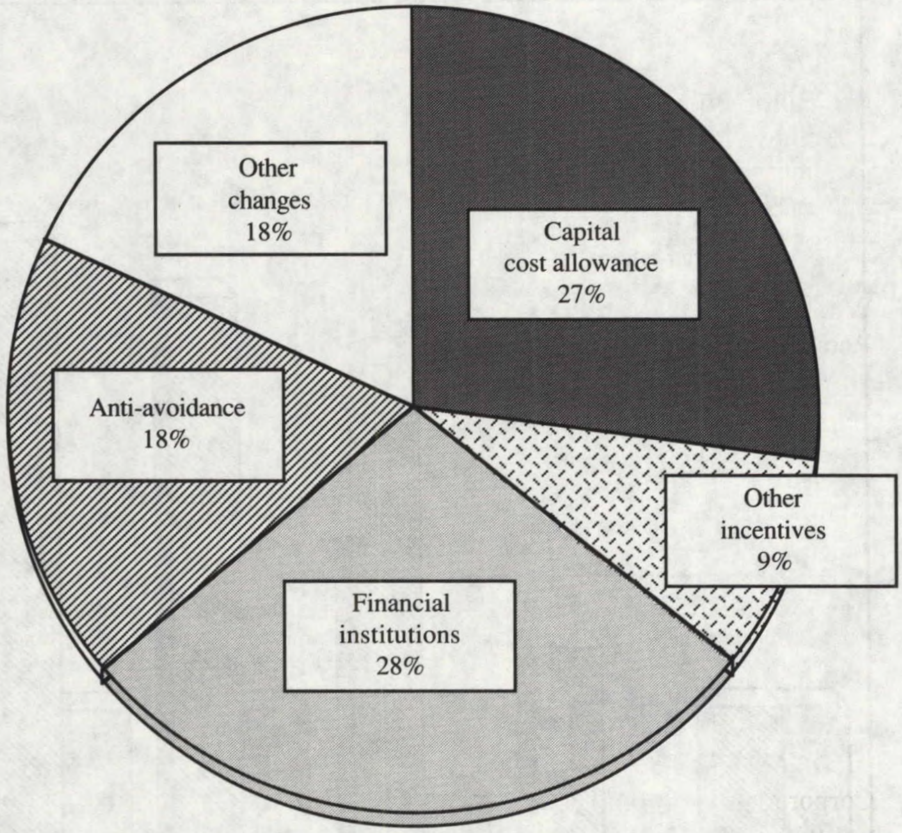


Table 4.14

Average Federal Tax Rates and Taxable Income as a Percentage of Financial Statement Income for Profitable Corporations

	Before tax reform		After tax reform	
	Average tax rate	Per cent of income taxed	Average tax rate	Per cent of income taxed
	(per cent of financial statement income)			
Agriculture, forestry and fishing	16.9	91.3	15.5	94.5
Mining	15.0	49.8	16.6	63.9
Oil and gas	21.4	67.9	20.3	75.4
Manufacturing	18.9	77.1	19.7	89.1
Construction	20.1	96.1	18.8	102.4(1)
Wholesale trade	24.5	94.7	22.6	101.0(1)
Retail trade	21.2	98.9	19.5	103.8(1)
Financial institutions, insurance and real estate	14.5	48.7	21.3	74.0
Services	20.4	94.1	18.9	98.8
Total, all industries	18.7	72.4	19.6	84.1

(1) Taxable income in some sectors can exceed financial statement income in a year if depreciation claimed on financial statements is greater than capital cost allowance claimed for tax purposes. This can occur where depreciation claimed for tax purposes has exceeded that deducted on financial statements in previous years as a result of accelerated write-offs.

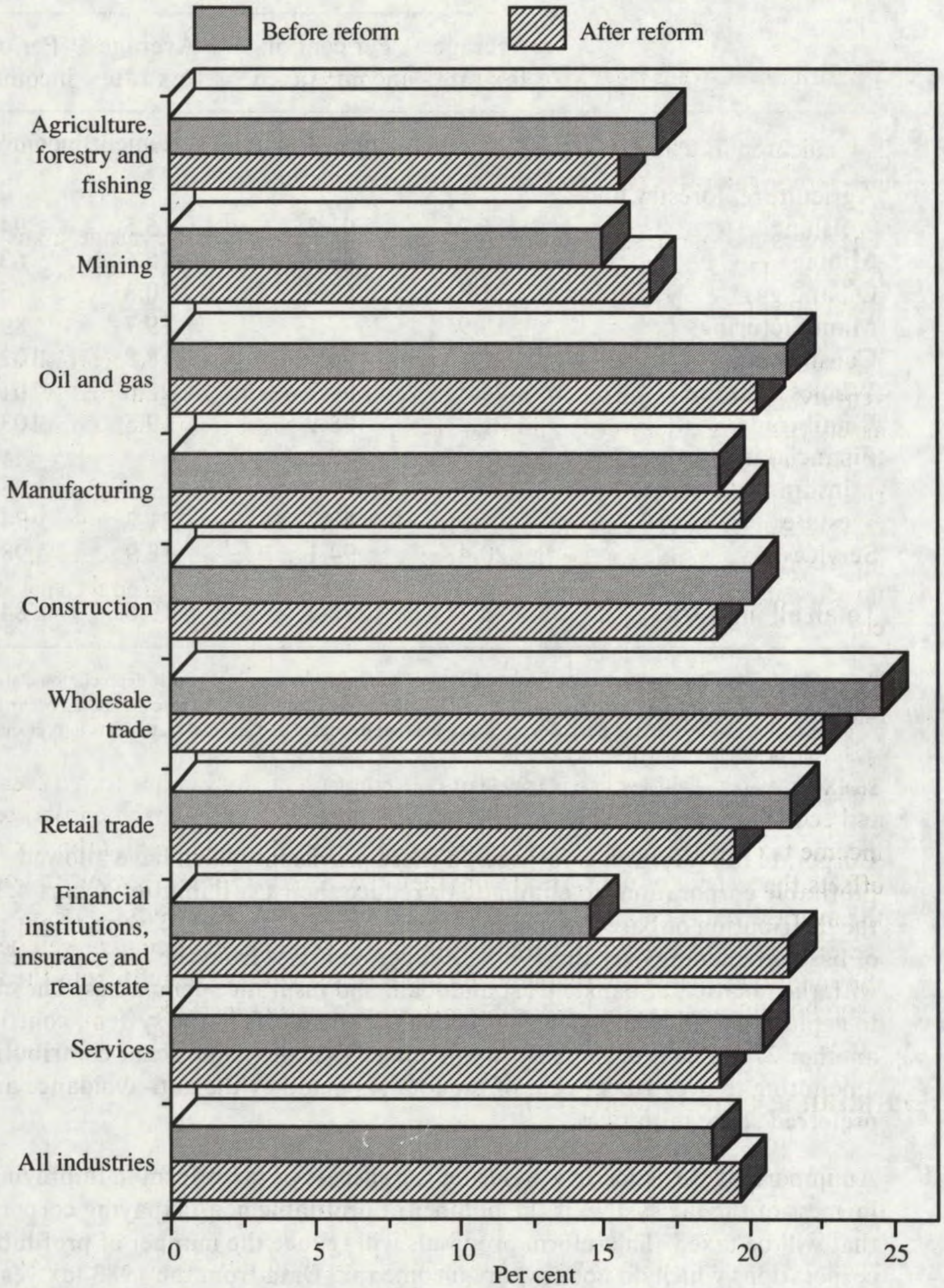
Source: "Income Tax Reform", Table 4.9, p. 43.

Corporate tax reform has focused on those provisions which have allowed profitable corporations to eliminate or reduce their tax liabilities. Chart 4.3 shows the distribution of base broadening by category of measure. Twenty-eight per cent of base broadening over the 1988-1992 period arises from the measures dealing with the taxation of banks, trust and loan, and insurance companies. The changes to capital cost allowances, which reduce the write-offs in the system, contribute another 27 per cent of the base broadening. A further significant contribution, amounting to over 18 per cent of the total, is made by the anti-avoidance and preferred share initiatives.

An important yardstick in measuring the success of tax reform in improving the fairness of the tax system is the number of profitable non-taxpaying corporations that will be taxed. The reform proposals will reduce the number of profitable corporations which do not pay any income tax. Data from the 1983 tax year suggest that some 110,000 of the total 320,000 profitable corporations did not pay tax in that year. Had the tax reform measures been fully in place in that year some 50,000 of these corporations would have become taxable.

Chart 4.4

Average Federal Tax Rates For Profitable Corporations



The levels of average tax rates before and after reform are shown in Table 4.14
Average tax rates are tax as per cent of income on financial statements.
Source: "Income Tax Reform", Chart 3.2, p. 27.

Of the remaining 60,000, 35,000 would have continued to be non-taxable because of the deduction of losses incurred in previous years while about 25,000 would have remained non-taxable because of incentives which would still be available to reduce their income to zero. For example, start-ups can be profitable but earn a low rate of return. Hence, a modest amount of accelerated deductions can make them non-taxpaying.

Reducing Variation in Corporate Tax Rates Among Sectors

As indicated in Chart 4.4, the effect of tax reform will be to reduce the variation in average tax rates paid by firms in different sectors.

The average tax rates of sectors which previously paid below-average taxes will increase. Those currently facing above-average tax rates will experience reductions.

Reduced tax rates will provide an incentive for firms to invest in profitable ventures. The reform package will even out incentives to invest across sectors and asset types. Significant variations in the pre-reform tax treatment of investments in different assets and industries have caused tax considerations to play a large role in the allocation of investment funds. Reform measures encourage investment through lower tax rates instead of through selective write-offs. As a result, investment decisions will be based more on the underlying profitability of investments and less on tax considerations. This will improve productivity and enhance economic growth.

Maintaining Support for Small Business

Tax reform recognizes the important contribution of small firms to job creation and economic growth. The proposals in this paper do not alter the corporate income tax burden on the small business sector, as the reduction in the tax rate offsets the impact of measures to broaden the tax base for this sector. In contrast, the average tax rate on large corporations increases, as shown in Chart 4.5. The tax on small firms as a percentage of their financial income remains well below that on larger firms. Shareholders of small firms will also benefit from the full $500,000 lifetime exemption on capital gains, starting in 1988.

5. Compliance and Administration

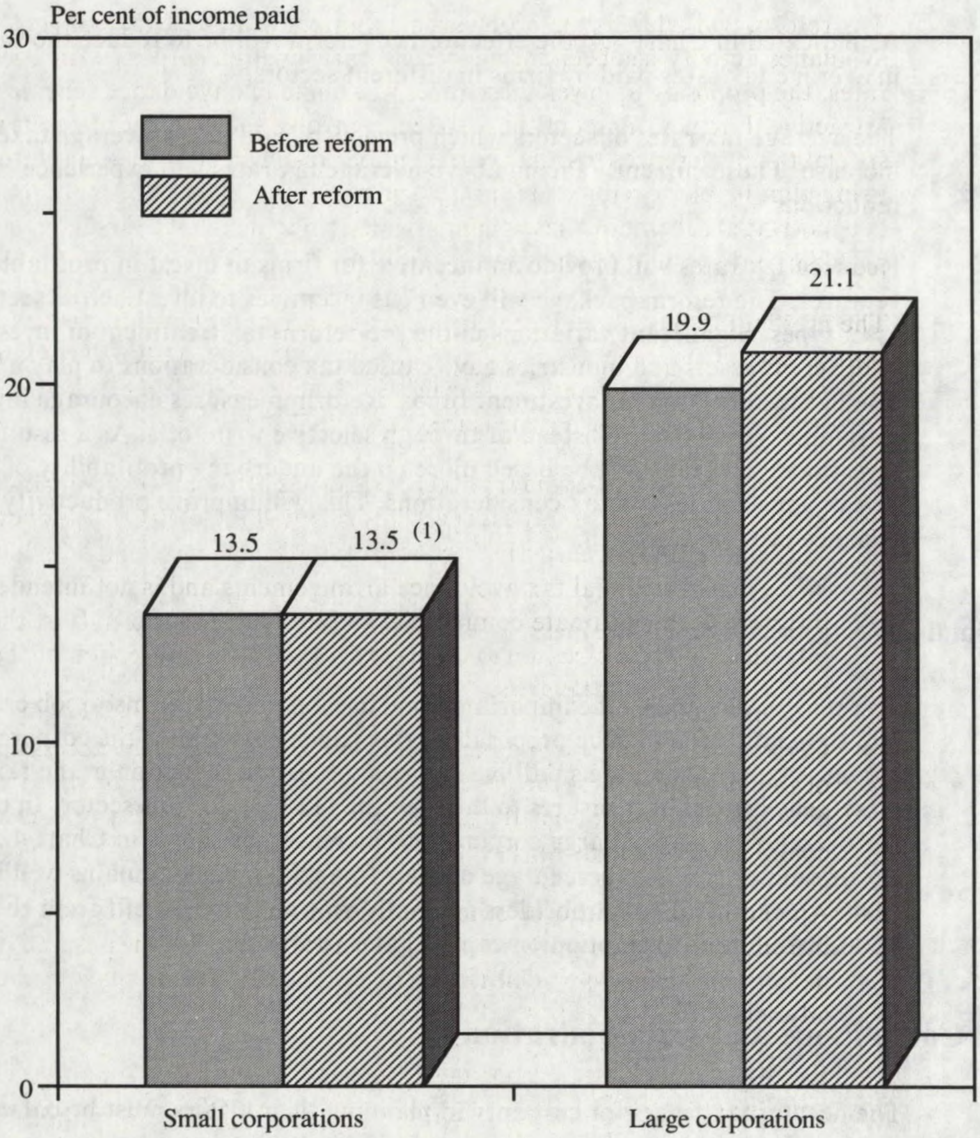
The need of taxpayers for certainty in planning their affairs must be balanced by the requirements of tax fairness and stable government revenues.

The government is concerned with the accelerating proliferation of tax avoidance schemes. Many opportunities for tax reduction occur as a result of sophisticated strategies that often involve the combined or serial application of various technical provisions to yield unintended tax advantages. These arrangements are generally

Chart 4.5

Average Corporate Tax Rates:

Small Firms Pay Less Than Large Ones



(1) The federal tax rate on small businesses can exceed the general 12% rate for such business due to the earning of investment income and income over the $200,000 annual limit which are taxed at the full federal rate.

Source : "Income Tax Reform", Chart 4.4, p. 46.

carried out primarily for tax advantage, and certain elements of the arrangement often have no genuine business purpose. The important objective of fairness requires action to curtail the increase in this type of tax avoidance activity.

The government has introduced many detailed rules to prevent specific types of tax avoidance transactions. Although such detailed rules are sometimes required, they are not always desirable. Technical anti-avoidance rules make the tax system more complex; they sometimes create additional unintended loopholes, and they do not deal with transactions completed before the amendments become effective.

Tax reform will address the problem in a number of ways. Since the growth of tax avoidance activity has been influenced, in part, by high corporate and personal tax rates, the proposals to lower these rates will make tax avoidance schemes less attractive. Further, many of these schemes involve the transfer of one taxpayer's special tax preferences to other unrelated persons. Many of these preferences are being eliminated or reduced in tax reform and this should have the same effect on tax-motivated schemes. These changes will help to deal with the tax avoidance problem, but explicit action is also necessary.

The present method of dealing with tax avoidance activity in the tax law needs to be improved. Consequently, measures are proposed to make anti-avoidance provisions more effective and to strengthen requirements for information reporting and penalties. The following measures are proposed:

- A new general anti-avoidance rule to prevent artificial tax avoidance arrangements will be introduced. This rule will introduce a "business purpose test" and a "step transaction" concept into the Income Tax Act. The rule will be aimed at artificial tax avoidance arrangements and is not intended to interfere with legitimate commercial or family transactions. It is, therefore, intended to strike a reasonable balance between the protection of the tax base and certainty for taxpayers.

- Certain specific anti-avoidance rules that will no longer be necessary in light of the introduction of the general anti-avoidance rule will be repealed. The elimination of some specific rules should reduce complexity and ease compliance problems for taxpayers.

- Amendments to reinforce other specific anti-avoidance rules will be introduced. Certain of these rules have anomalies, weaknesses and other defects that have been identified by Revenue Canada, taxpayers and their advisers. These problems will be corrected.

- Expanded information reporting requirements will be introduced. These amendments are aimed at ensuring better taxpayer reporting and compliance.

- Existing tax penalties and offences will be rationalized and increased, particularly for repeated non-compliance by taxpayers.

The proposed measures will reduce the recent legislative trend towards an array of specific anti-avoidance rules and the resulting increase in complexity of our tax laws. These measures will improve the government's ability to deal more effectively with repeated non-compliance and will provide a new statutory basis for the courts to rule against artificial tax avoidance arrangements.

These anti-avoidance measures, when combined with the initiative to limit after-tax financing, will contribute about 18 per cent of the total corporate income tax base broadening over the next five years.

6. Federal Sales Tax Changes and Other Transitional Measures

Pending the replacement of the existing sales tax with a multi-stage tax, changes to the existing federal sales tax are required to correct some of its most serious inequities and to stem the erosion of the tax base through the use of tax avoidance mechanisms. The government is also proposing other sales tax measures which, together with the corporate tax changes, will provide the additional revenues required to proceed with personal income tax reform in a fiscally responsible way.

The following changes are proposed to be effective January 1, 1988, to limit erosion of the sales tax base, alleviate some of the more pressing competitive inequities caused by the sales tax, and raise additional revenue.

- The federal sales tax will apply to sales by marketing companies related to the manufacturer.
- The federal sales tax will be shifted from the manufacturers' level to the wholesale level for a limited range of products.
- Paint and wallpaper will be deleted from the list of construction materials that are taxable at 8 per cent and will be taxed at the general rate of 12 per cent.
- The sales tax will be extended to telecommunication services, such as telephone and telex services, at a rate of 10 per cent. Service charges for local residential telephone lines will be exempt from this tax. The sales tax on cable and pay television services will be increased to 10 per cent from the present 8 per cent.

To ensure that low-income individuals and families are protected, the existing refundable federal sales tax credit will be increased from $50 to $70 per adult and from $25 to $35 per child. The credit will be reduced by 5 per cent of family net income in excess of $16,000.

The expected net revenue yield from these measures will be $1.1 billion in 1988-89 and $1.2 billion in 1989-90.

To improve cash management of tax liabilities, assist with deficit management in the implementation and transition of the first stage of tax reform, and achieve ongoing savings in public debt charges, the government proposes to accelerate the collection of certain taxes.

- Effective April 1988, the collection of federal sales and excise taxes will be accelerated for all taxpayers. As well, large firms will be required to remit twice-monthly.

- Effective January 1990, the remittance of deductions withheld at source in respect of personal income taxes, unemployment insurance premiums and CPP contributions will be accelerated to four times per month for larger employers.

- Effective January 1990, remittance of personal income tax instalment payments made by individuals required to file quarterly will have to be remitted by the 15th day of the relevant quarter.

These measures will contribute one-time cash increases of $1.6 billion in 1988-89 and $1.1 billion in 1989-90. They do not affect the tax liabilities of individuals or firms, but result in ongoing savings in public debt charges.

Details of these measures can be found in Part B of "Sales Tax Reform" and Chapter 5 of "Income Tax Reform".

B. Proposals for Reform: Stage Two

In the second stage of tax reform, the government will introduce a new sales tax system. At the same time, the existing personal and corporate income surtaxes will be removed and there will be further income tax reductions for middle-income individuals and families. Accompanying the new sales tax will be a significantly enriched refundable tax credit to ensure a greater degree of tax fairness for low- and middle-income Canadians than currently exists.

1. The Multi-Stage Sales Tax

The government proposes to replace the existing federal sales tax with a broad-based multi-stage sales tax that extends to the retail level. This multi-stage tax would be a form of value-added tax. It would be levied on and collected from businesses, in stages, as goods move from primary producers and processors to wholesalers, retailers and finally to consumers.

Under this sales tax system, businesses will charge tax on their sales and claim a credit for any tax paid on their purchases. In its simplest form the tax is calculated by taking taxable sales made by a business during a given period, multiplying them by the tax rate,[4] and then subtracting any tax paid on business purchases. In essence, this system is equivalent to applying the tax to the value added by each business.

(4) Until final decisions are taken about the comprehensiveness of the tax base, it is not possible to specify the actual rate. For the purposes of the discussion in this paper, a rate of 8 per cent is used. This issue is discussed more fully in Chapter 3 of "Sales Tax Reform".

The basic method for calculating the multi-stage tax by a firm is set out in Chart 4.6.

Taxable sales will include sales of most goods and services in Canada. They will not include any export sales. A firm making sales exclusively in the export market will have taxable sales of zero but nevertheless will be eligible for a refund arising from the credit for tax paid on purchases.

Firms will be entitled to claim input tax credits on the purchase of any taxed goods or services that are used in business. If a firm's credits for taxed purchases exceed its tax payable on taxable sales it would be entitled to a refund. This refund feature will ensure that the sales tax does not penalize companies for building inventories and, by removing the tax from business inputs without delay, it acts in favour of business investment, expansion and export sales.

Imports will be taxable at the time of importation.

The overall operation of the tax is illustrated in Chart 4.7. This depicts the production, distribution and final sale of a piece of household furniture, beginning with the cutting of logs by a logger, who sells them to a sawmill for $100. If the tax rate were 8 per cent, for example, the logger would also charge a tax of $8. Continuing along the production and distribution chain, the sawmill will have sales of $150 on which it would charge $12 in tax. After deducting $8 paid in tax on its purchase of logs, it would have a net tax liability of $4. The manufacturer and the retailer calculate their net tax liability in the same way as the logger and the sawmill. They charge tax on their sales and claim credits for taxes already paid on their purchases. The retailer is charged $24 in tax by the manufacturer on its sale of $300. In turn, the retailer charges the consumer $32 or 8 per cent of the final sale price of $400. In calculating its tax liability the retailer would claim a credit for the $24 in tax charged by the manufacturer and remit $8 in total tax. Over the four stages of this production and distribution chain, the government would collect a total of $32, which is equal to 8 per cent of the pre-tax retail price of $400 to the consumer.

This simplified example illustrates the basic properties of the multi-stage tax. Any tax on sales charged by an intermediary producer, like the logger, the sawmill and the manufacturer in this example, is fully credited at the next stage of the production and marketing chain. The only tax that is not refunded is the one charged by the retailer on final sales to consumers. In this way, while collected in stages through the production and marketing network, the multi-stage tax is a tax on final consumption. The structure and operation of the multi-stage tax are described more fully in Chapter 3 of "Sales Tax Reform".

By extending to the final point of consumption, the multi-stage tax offers a number of advantages over the present federal sales tax.

A multi-stage tax is neutral. It is a uniform percentage of the final price of goods and services to consumers. As a result, unlike the current sales tax, it provides no incentives to businesses to alter their production or distribution systems nor does it affect their competitive positions in the market. Because it extends to the retail

Chart 4.6

Multi-Stage Sales Tax

Basic Calculation

Taxable Sales

times

Tax Rate

equals

Tax Charged on Sales

minus

Tax Paid on Purchases
(Input Tax Credit)

equals

Tax Payable
(if positive)

e.g.	Tax*
Sales: $200,000	$16,000
Purchases: $150,000	(12,000)
Tax payable	$ 4,000

Tax Refundable
(if negative)

e.g.	Tax*
Sales: $180,000	$14,400
Purchases: $200,000	(16,000)
Tax refund	($1,600)

* Assumes a tax rate of 8 per cent.

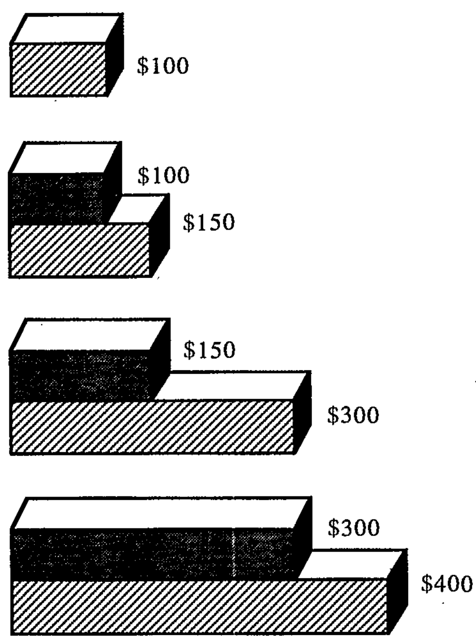
Chart 4.7

Multi-Stage Sales Tax

An Illustration of Furniture Manufacture and Distribution

Purchases

Sales (excluding tax)



	Tax on sales	Input tax credit	Net Tax
Logger	$ 8	-	$ 8
Sawmill	$12	$ 8	$ 4
Manufacturer	$24	$12	$12
Retailer	$32	$24	$ 8
Total			$32

Note: Purchase and sale amounts shown in the chart do not include tax. In order to pass on the tax, each vendor would charge tax in addition to the amounts shown. Thus, for example, the logger would charge the sawmill $108.

level, the final amount of tax on a product is independent of the production and distribution chain. It depends only on the final price to consumers. This is fairer. The tax treats business firms uniformly, regardless of how they manufacture and distribute their product. By ensuring a uniform effective tax rate, the multi-stage system also avoids any tax-induced distortion in consumers' perceptions of the values of the goods and services they buy.

A multi-stage tax completely removes the tax on business inputs. Providing credits for the tax already paid on business purchases is the most simple and effective means of removing tax from products purchased and consumed in the production of other goods and services. The efficiency of this system of input tax credits is one of the great advantages of the multi-stage tax, rendering it superior to other systems of commodity taxation. Under the current system almost half of all the revenues collected under the federal sales tax is derived from business inputs. Relieving them of tax not only removes an impediment to investment, growth and jobs, it helps consumers. It ensures that the goods and services they buy are not burdened by hidden taxes.

A multi-stage tax has no bias favouring imports. Under the current federal sales tax, marketing and other costs can be added to the price of imported products after tax is imposed at the point of importation. Usually, this leads to lower effective tax rates on imported goods, placing Canadian producers at a distinct disadvantage. In contrast, because the multi-stage tax extends to the retail level, it ensures a uniform tax on both imports and domestic goods, regardless of when costs are added to imports. The capacity of a multi-stage tax to re-balance the scales of competition by removing an unfair burden from Canadian firms is an important advantage.

A multi-stage tax would strengthen the competitiveness of Canadian exports. Today, while there are no direct taxes on exported goods, the hidden taxes imposed on business inputs by the existing sales tax represent a significant impediment to our export performance. One of the main purposes of the multi-stage sales tax is to relieve this unnecessary burden. To do this, the tax will not apply to export sales, and exporters will be allowed to claim a full credit for any tax already paid on purchases of goods and services. In this way, our exporters will be placed on a fairer, more competitive footing.

The Sales Tax Base and the Sales Tax Credit

Clearly, before implementing a multi-stage sales tax there are a number of important issues to be addressed. Among these is the critical question of which goods and services should be included in the tax base. The resolution of this question has consequences both for the rate at which the tax must be levied and for the size and design of the refundable sales tax credit which will accompany the new sales tax system. Since the amount of revenues to be raised through sales taxes will be the same regardless of the base, the rate would be higher if exemptions were provided.

The key factors involved in determining whether certain basic commodities should be included in the base are illustrated below using food as a case in point. They apply equally to a number of other goods that usually are thought of as "necessities".

Even though food is taxed in many other countries and some foods are now taxed in Canada, taxing food is understandably an emotional and controversial issue. Its sensitivity reflects our Canadian tradition of concern for those in need. The prevailing view among Canadians has long been that keeping food exempt from tax is required to help shield low-income families from the disproportionate burden of sales taxes. An important question, however, is whether or not an exemption is the best means to achieve this result.

In 1982, the last year for which detailed figures are available, statistics show that households with incomes below $25,000 accounted for about half of all Canadian households, but they purchased less than 36 per cent of food consumed in Canada. As illustrated in Chart 4.8, the other half of all households, with incomes greater than $25,000, purchased more than 64 per cent of food consumed in Canada. In other words, 64 per cent of the tax savings from exempting food goes to the 50 per cent of households who have incomes above the median.

Exempting food from sales tax gives higher-income people a greater absolute tax benefit than those at lower-income levels. This is because higher-income people spend more on food and, in particular, more on expensive foods and restaurant meals.

This result is generally true for most basic commodities. Exemptions provide greater relative benefit to lower-income households but greater absolute benefits to higher-income households. Exempting certain items leads to higher tax rates on everything else, including all other goods and services bought by low-income households, to raise the revenue required to fund public programs.

A better way to make a sales tax fair is to offset the effects of the total tax paid by lower-income families with a refundable sales tax credit. By making the credit refundable, all low-income Canadians receive the credit, even if they do not pay income tax. What is required to qualify is to file a tax return, as most Canadians already do. By phasing the credit out for households with income above a threshold level, the benefits are appropriately targeted to lower-income families. By prepayment of this credit, those in need will receive a payment before they have to purchase goods and services and pay the sales tax.

The refundable, prepaid credit accomplishes the goal of enhanced fairness. Its comparative effectiveness in assisting low-income households is illustrated by Chart 4.9.

With a refundable, prepaid credit, the issue of taxing food – or any other basic commodity – depends on balancing the following considerations.

If food and other goods are taxed, they would cost more. The refundable, prepaid credit would be larger. The tax rate for all products would be lower than with exemptions.

If food and other goods are not taxed, their prices would be lower. The refundable, prepaid credit would not be as great. And, to raise the same amount of revenue, the tax rate for all other products would be higher.

2. Implementing the Multi-Stage Tax

The new sales tax could be implemented in the form of a National Sales Tax system, replacing both the current federal sales tax and the existing provincial retail sales taxes. Alternatively, it could be designed to operate only at the federal level, with provinces continuing to collect their own sales taxes separately. Whether implemented on a national basis or at the federal level only, the tax would be based on the principles and structure of the multi-stage tax.

The National Sales Tax

Under the National Sales Tax system, within each province there would be one tax rate. In addition to the federal component of the rate, which would be uniform across the country, the National Sales Tax rate applicable in a province would incorporate the rate set independently by the provincial government. Because provinces would retain the right to determine their own rates, the National Sales Tax rate would vary among provinces. The tax would be legislated separately by the two levels of government.

For a business that makes all its sales and purchases within one province, the calculation of the tax would based on one rate. Where a business engages in inter-provincial trade, the tax would operate on the basis of the destination principle. The National Sales Tax rate applicable on any sale would be the rate that applied in the province to which the goods were shipped.

To simplify administration and compliance, the National Sales Tax would apply on a common federal and provincial base in all participating provinces. The base would be agreed by the two levels of government. Without a common base, little tax simplification would be possible.

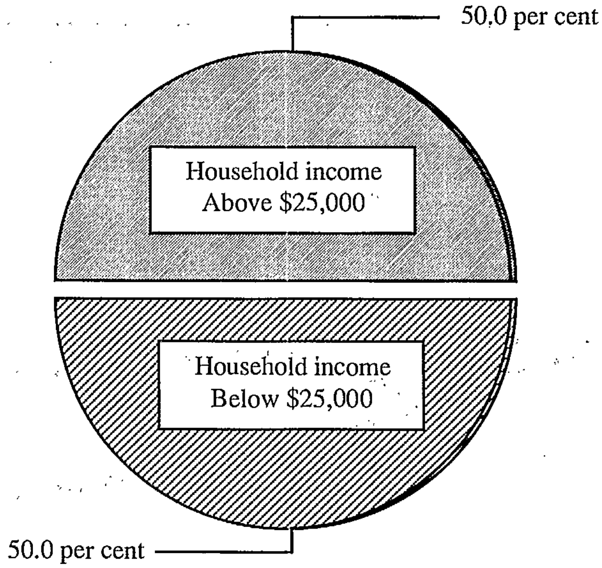
The base would not necessarily have to be all-inclusive; exemptions would be possible. But the narrower the base, the higher would be the rates of tax to achieve a given revenue objective.

To accommodate variable provincial rates, the National Sales Tax would be calculated separately on sales invoices. Without invoicing, it would not be possible for businesses to separate their sales to and purchases from provinces with different tax rates, making it virtually impossible for them to calculate accurately their input credits and overall tax liability. However, because it would replace the existing provincial taxes as well as the federal sales tax, it offers an opportunity to minimize the overall compliance burden and administrative cost, compared with options that would reform only the federal sales tax and leave provincial retail sales taxes in place.

Chart 4.8

Higher-Income Households Spend More on Food Than Lower-Income Households

Population



Food consumption

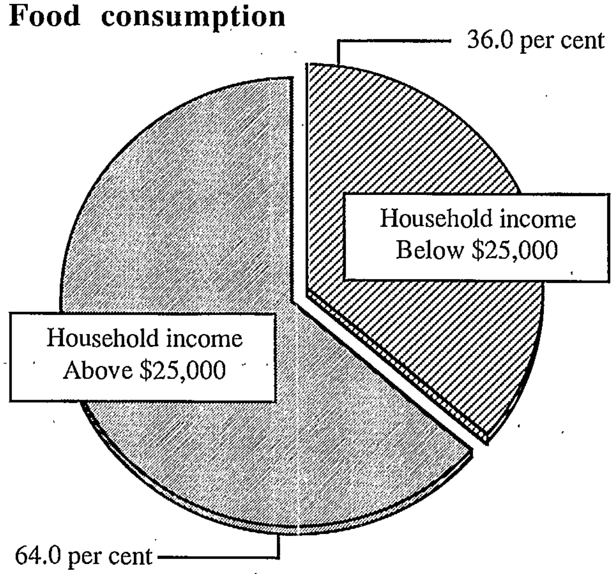
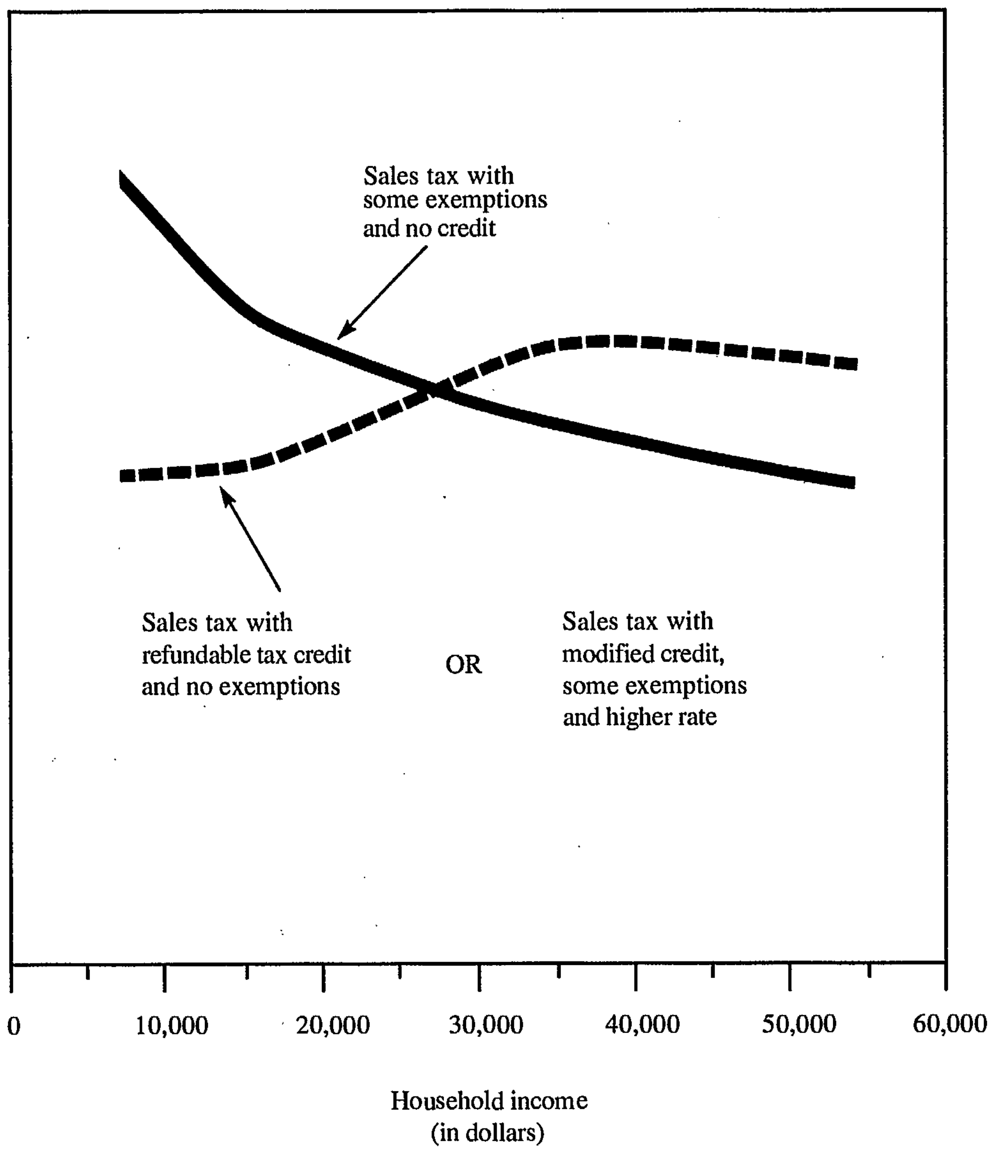


Chart 4.9

Illustration of Refundable Sales Tax Credit and Exemptions



Note: The lines are drawn to yield the same revenues, net of the credit.

The National Sales Tax would be integrated with the personal income tax system by significantly enriching and broadening the existing refundable sales tax credit. The credit would offset the impact of sales tax reform on low-income families and would make the new sales tax system – even with a broad base – much more progressive than the existing sales tax systems. There would be considerable flexibility in the manner in which such credits would be delivered. Provinces would have the option of providing their own credits separately from federal credits, or of developing a joint system.

The National Sales Tax offers a number of advantages. It would:

- maximize the economic benefits of reform by fully removing the tax on business inputs at both levels of government, thereby strengthening the competitiveness of Canadian industries;
- simplify compliance for taxpayers;
- eliminate duplication of tax administration; and
- provide fairer tax treatment of firms, sectors and households.

Preliminary discussions on the possibility of a National Sales Tax have taken place with provincial governments. While no province has made a commitment to a national system the government believes that the opportunity of truly national sales tax reform warrants further examination and discussion to determine whether a consensus can be reached.

The Goods and Services Tax and the Value-Added Tax

Should a consensus with the provinces on a national system not be achievable, the government will replace the current federal sales tax with a federal-only multi-stage tax. A new sales tax at the federal level would also meet the goals of tax reform. It would represent an important step forward in tax simplification, tax fairness and in improving Canada's industrial competitiveness. It would be far better than the current federal sales tax and would represent a major improvement in Canada's tax system. A federal-only multi-stage tax would also be accompanied by the removal of the income tax surtaxes, further income tax reductions for middle-income taxpayers, and an enhanced, refundable, prepaid sales tax credit for lower- and middle-income Canadians.

The government will consider two alternative mechanisms for a federal-only multi-stage tax.

- A federal Goods and Services Tax which would be levied at a single rate on virtually all goods and services in Canada.
- A federal Value-Added Tax which would allow greater flexibility in deciding which goods and services would be taxed. Invoices would be required.

(i) Federal Goods and Services Tax

A federal Goods and Services Tax, applied at a uniform rate to virtually all goods and services in Canada, would not require a separate tax calculation on each invoice.

A comprehensive base also means that a business's tax liability for a period could be calculated using information from the books of account already maintained by firms. This would simplify compliance and keep business costs down.

A federal tax structured in this way could operate in parallel with provincial retail sales tax systems. Retailers would be likely to include the federal tax in their prices and the provincial tax would be applied on that price at the time of sale. From the perspective of the vendor, the relationship between the operation of the federal and provincial tax systems would remain much the same as it is today.

A Goods and Services Tax would be accompanied by a substantially enriched refundable sales tax credit for lower- and middle-income Canadians. The tax credit would be structured along the line of the current sales tax credit. It would vary by family size and would be gradually phased out through the middle-income ranges.

A broadly-based federal Goods and Services Tax would achieve many of the goals of federal sales tax reform. It would promote economic efficiency and competitiveness and remove all the distortions of the existing federal sales tax. By minimizing exemptions and utilizing a single rate, it would be the simplest approach from the perspective of both tax administration and taxpayer compliance. Finally, the inherent regressivity in a broadly-based sales tax would be eliminated through the enhancement and prepayment of the refundable sales tax credit.

The major disadvantage of a federal Goods and Services Tax is that it does not provide the flexibility to exempt particular products or sectors of the economy. This is feasible only under a system with tax invoicing.

(ii) Federal Value-Added Tax

The federal Value-Added Tax would also be a broad-based tax. However, the explicit invoicing of tax would provide the flexibility to exempt selected goods and services or selected classes of business operators. This system would be similar to those operating in European countries and several other countries around the world.

In light of the fact that the base would be more selective, businesses would need to substantiate their claims for input credits by invoices showing the tax charged.

The extent to which the refundable sales tax credit would be enriched with a federal Value-Added Tax would clearly depend on how broad the base is. To the extent that exemptions were numerous, the credit would not be increased as much.

Like the Goods and Services Tax, the federal Value-Added Tax would also remove the inefficiencies of the current federal sales tax. First, because the tax would extend to the retail level, it would apply uniformly to taxable goods and services that flow through different production-distribution channels. Second, it would permit removal of virtually all tax on business inputs and thus strengthen the competitive position of Canadian firms. Third, it would eliminate the bias in favour of imports. In addition, there would be gains in economic efficiency, though not to the same extent as under a tax applied on a comprehensive base.

The main disadvantage of this option is the additional paperburden and compliance costs it imposes on retailers. In fact, if the exemptions were numerous, the tax could become a significant burden on retailers, who would have to cope with two sales tax systems – a federal Value-Added Tax and a provincial retail sales tax – each with different tax rates and tax bases.

Conclusion

The government will implement a broad-based multi-stage sales tax. Its implementation is an essential element of comprehensive tax reform. Its design by legislators will be based upon one of the alternatives set out in this document. Regarding the choice between alternative mechanisms for such a tax, the government proposes to examine the option of the National Sales Tax with the provinces, who have expressed initial interest in building a joint system along these lines.

5. Economic and Fiscal Impacts of Tax Reform

1. Impacts on Economic Performance

The current tax system increasingly has become an obstacle to sustained economic growth. Too many private economic decisions are being made on the basis of tax incentives rather than economic incentives; incentives to work, save and invest are being eroded; our industries are being put at a competitive disadvantage in both domestic and foreign markets.

Comprehensive tax reform will address these distortions and inequities in a substantial way, strengthen incentives to save and work, and create a more efficient and competitive economy. By improving our international competitiveness, and strengthening the structure of our domestic economy, we will better adapt and prosper in a changing and uncertain world environment. Tax reform will allow us to continue to build an even stronger foundation for sustained economic growth and steady improvement in the economic and social well-being of all Canadians.

Personal Income Tax Reform

One of the main features of personal income tax reform is the reduction in marginal tax rates for the majority of Canadians. This means that Canadians will keep more, and in many cases substantially more, of each additional dollar they earn. Greater after-tax earnings will provide an incentive for more Canadians to enter the labour force and, for those already employed, to work longer and more productively. The second stage of tax reform will reinforce these incentives.

Increases in labour supply will have an important and positive impact on Canada's economic prospects. Canada's international competitiveness will be enhanced, the trade balance will improve and more jobs will be created. Increased employment will further raise domestic demand, thereby producing a virtuous circle of higher labour supply and greater employment opportunities.

Personal income tax reform will strengthen incentives to save. A higher rate of domestic savings over the longer term should provide a larger, and less costly, pool of funds for investment activities. Increases in investment will expand the productive capacity of the Canadian economy, thereby raising productivity and enhancing competitiveness. As domestic savings move into better balance with domestic investment, the current account of the balance of payments should improve.

Corporate Income Tax Reform

Corporate tax reform will reduce the variability of corporate tax burdens across industries and among capital assets. Large differences in effective tax rates on new investment among industries mean that investment projects earning very different rates of return before tax can be equally profitable after tax. The reduction in the variability of these tax rates across sectors means that the corporate tax system will have a less distortionary effect on new investment decisions.

Corporate tax reform will also reduce the relative tax disadvantage currently affecting labour-intensive industries and firms as current tax incentives to substitute capital for labour in the production process are reduced. Reducing such tax-induced distortions will improve economic efficiency.

The current system of high statutory corporate rates encourages business to finance the acquisition of assets by debt rather than equity. The experience of the 1980-1982 period provides a clear demonstration of how an economy can suffer from excessive corporate leverage. The lower corporate tax rates resulting from tax reform will reduce the tax value of the interest deduction, thus lowering the tax incentive for debt financing relative to equity.

Sales Tax Reform

Sales tax reform will eliminate significant tax-induced distortions in the economy. This will improve the structure and competitive performance of the Canadian economy. A broad-based multi-stage sales tax will remove the tax on business inputs, treat domestic and imported goods equally, and distribute the tax load more evenly across a broader range of goods and services. These effects will also lead to greater production opportunities, employment creation and higher national income. In addition to these benefits, sales tax reform will also have appreciable short- to medium-term impacts on the overall economy. Growth rates of output and employment will increase in response to higher investment spending and a positive impact on Canada's trade balance.

Slightly more than one-third of the value of final expenditures on investment is now subject to federal sales tax at either the 8-per-cent or 12-per-cent rate. Thus, the effect of the removal of the federal sales tax on investment goods would be roughly equivalent to a 4-per-cent reduction in the cost of capital. Over the longer term, the result could be an increase in the level of the desired capital stock by as much as 4 per cent.

The shift from a narrowly-based federal sales tax to a broad-based multi-stage sales tax will have some impact on the prices of previously untaxed goods and services. This one-time increase in the prices of goods and services which are not now subject to tax will be offset, to a certain degree, by price reductions resulting from the lowering of the tax rates on currently taxable commodities. As well, for many Canadians, the increased costs would be offset, or more than offset, by the refundable sales tax credit, the removal of the surtax on personal income, and further personal income tax cuts. After a brief period, price trends would return to normal. As such, the one-time price adjustment should not find its way into the determination of other costs, and would not increase export prices.

The major economic impact of the second stage of comprehensive tax reform will be its strongly beneficial effects on the competitiveness of Canadian industry and the incentives of Canadian industry to invest. Comprehensive tax reform will lead to a more efficient allocation of resources in the Canadian economy, a more competitive economy in the global marketplace, and increased potential for growth and job creation in the 1990s.

2. Impacts on Fiscal Performance

Key considerations in tax reform have been to ensure that its impact on the deficit is basically neutral, and that it increase the reliability of tax revenues.

The cumulative impact of the tax reform and related measures on the deficit and net debt over the 1988-89 to 1991-92 period is negligible. But the beneficial effects on Canada's longer-term fiscal situation go beyond the direct fiscal impacts.

- Over the past decade the flow of revenues from the tax system has become less stable and more difficult to predict. The initiatives proposed under stage one of comprehensive tax reform will improve the stability and predictability of federal tax revenues. The broadening of the tax bases and the elimination of selective tax preferences, together with the lowering of tax rates and the introduction of general anti-avoidance rules, will address the prospective erosion of tax bases that would have occurred in the absence of tax reform.

- In the absence of tax reform, increasing reliance on personal income taxes would have continued. The tax measures in the first stage of tax reform will lower the share of personal income taxes and increase the shares of both corporate income and sales taxes. The corporate tax share will increase from an estimated 15.6 per cent in 1987-88 to 17.2 per cent by 1991-92. The second stage of tax reform will bring about further re-balancing of the shares of the main tax revenues as the federal sales tax is replaced by a broad-based multi-stage sales tax, the personal and corporate surtaxes are removed and there are additional personal income tax reductions.

Tax reform will help the government meet its fiscal principles over the medium term. Since November 1984, the government's medium-term fiscal strategy has been based on four principles:

- to reduce the growth of the public debt to no more than that of the economy over the medium term: that is, to stabilize the debt-to-GDP ratio;

- to achieve continuing, sizeable year-over-year reductions in the deficit;

- to achieve substantial year-over-year reductions in the government's financial requirements; and

- to ensure that the greater part of the fiscal progress is achieved through effective expenditure restraint and good management.

These principles have been pursued aggressively and much progress has been made despite unforeseen developments, primarily originating from adverse international events, that have slowed fiscal progress from that which had been planned. In particular, the dramatic fall in oil and grain prices in 1986 and the likelihood that these commodity prices will not recover to earlier levels over the remainder of the decade has meant a substantial loss in income of the Canadian economy relative to what was expected at the time of the February 1986 budget. This in turn has put upward pressure on the medium-term deficit track through the impacts of lower oil prices on corporate income tax revenues and of lower grain prices on certain statutory expenditures.

Fiscal Impacts of Tax Reform

Panel A of Table 5.1 presents the direct revenue and expenditure impacts of the personal and corporate tax measures in the first stage of tax reform.

Most of the personal income tax proposals will be fully implemented in the 1988 taxation year but the adjustment of the withholding tables on July 1, 1988 means that there will be large refund payments in fiscal year 1989-90. By 1991-92, the tax reform proposals will reduce personal income tax revenues by approximately $2.5 billion per annum.

The corporate tax changes will increase the corporate tax share of total federal revenues. Corporate tax revenues are about $530 and $625 million higher, respectively, in fiscal years 1988-89 and 1989-90 as a result. As the measures become fully phased in, the increase in corporate tax revenue will grow to about $1.5 billion by 1991-92.

The total direct revenue impacts of the personal and corporate tax measures would, in the absence of other measures, result in an increase in the deficit of $1.2 billion in 1988-89 and $3.2 billion in 1989-90, as the tax measures are almost fully phased in over a two-year transition period. Beyond this transition period, the revenue effects of these tax changes will increase the deficit by about $1 billion per annum. As well, these measures will directly increase the deficit by an additional $350 to $400 million per year through higher expenditures under the equalization program and because of higher Established Programs Financing cash payments to the provinces due to changes in the value of tax points.

Because sales tax reform will be implemented in a second stage, responsible fiscal management requires raising additional revenues from the existing sales tax system. Actions are also being taken to accelerate the collection of sales and excise taxes and the remittance of income taxes deducted at source. These revenue increases are outlined in Panel B of Table 5.1.

Table 5.1

Fiscal Implications of Stage One of Tax Reform

A. Total Direct Revenue and Expenditure Impacts of the Personal and Corporate Tax Measures	1988-89	1989-90	1990-91	1991-92
		(millions of dollars)		
Revenue impacts				
Personal income tax				
Conversion of exemptions to credits and marginal tax rate reductions	−2,185	−5,910	−4,600	−4,905
Base broadening and other measures	480	2,070	2,255	2,495
Net personal income tax reductions	−1,705	−3,840	−2,345	−2,410
Corporate income tax				
Tax rate reductions	−635	−1,545	−1,645	−1,665
Base-broadening measures	1,165	2,170	2,810	3,190
Net corporate income tax increases	530	625	1,165	1,525
Total net revenue reductions	−1,175	−3,215	−1,180	−885
Expenditure impacts				
Increased payments under Established Program Financing and Equalization	340	360	385	395
B. Related Revenue Measures				
Changes to the federal sales tax (FST) and the refundable sales tax credit				
Shift in federal sales tax to wholesale level for selected items and change in the treatment of marketing companies	295	310	315	330
10-per-cent tax on specified telecommunication and cable services	870	945	1,000	1,055
Tax at general rate on paint and wallpaper	60	60	65	65
Increase in refundable sales tax credit by $20 per adult and $10 per child	−120	−150	−155	−160
Net increase in FST revenues	1,105	1,165	1,225	1,290
Tax liability management				
Acceleration of source deductions and quarterly instalments of personal tax		1,100		
Acceleration of sales and excise tax payments	1,600			
Total revenue increases resulting from tax liability management	1,600	1,100		
Total net revenue increases	+2,705	+2,265	+1,225	+1,290
Deficit implications of stage one of tax reform	−1,190	1,310	340	−10

Fiscal Outlook

Notwithstanding the impacts of lower oil and grain prices in 1986, the deficit for fiscal year 1986-87 is now estimated at $31.0 billion, $1.0 billion below the February 1987 budget projection, and $3.4 billion below the 1985-86 deficit of $34.4 billion. Program spending for fiscal year 1986-87 is estimated to be $89.4 billion, the target set out in the February 1986 budget and reconfirmed in the February 1987 budget. Revenues will be somewhat stronger than expected in the February 1987 budget, largely reflecting stronger than anticipated corporate income tax collections in the first quarter of 1987. Financial requirements, excluding exchange fund transactions, in 1986-87 are estimated at $21.6 billion, $2.4 billion less than forecast at the time of the February 1987 budget, resulting from both the improvement in the deficit and increases in the net source of funds from non-budgetary transactions.

The pace of deficit decline is expected to slow temporarily in fiscal years 1988-89 and 1989-90 (Table 5.2). This reflects the ongoing impacts of lower oil and grain prices in 1987-88 and beyond, and the transition to the reformed corporate and personal income tax systems.

Table 5.2

The Medium-Term Outlook for the Deficit, Financial Requirements, and Net Public Debt

	Estimate	Projection				
	1986-87	1987-88	1988-89	1989-90	1990-91	1991-92
Budgetary deficit						
$ Billions	31.0	29.3	28.9	28.6	26.1	23.5
Percentage of GDP	6.1	5.4	5.0	4.7	4.0	3.4
Financial requirements						
$ Billions	21.6	21.3	22.3	19.7	16.0	12.7
Percentage of GDP	4.3	4.0	3.9	3.2	2.5	1.8
Net public debt						
$ Billions	264.5	293.8	322.8	351.4	377.5	401.0
Percentage of GDP	52.4	54.6	56.2	57.3	58.2	58.2

Looking ahead to the 1990s, the deficit and financial requirements are projected to show substantial declines. By 1991-92, the federal deficit is projected to decline a further 20 per cent from the estimated 1987-88 level, and financial requirements will be down 40 per cent from the estimated level for 1987-88. The debt-to-GDP ratio is expected to stabilize by 1991-92, constituting a key milestone in the government's medium-term fiscal strategy. Underlying these improvements are steadily declining expenditures as a percentage of GDP and a relatively stable ratio of revenues to GDP.

The Canadian economy is currently in its fifth year of economic expansion, and is well positioned to continue to grow steadily over the years ahead. But Canada's medium-term economic and fiscal prospects will be affected by international economic developments, in particular the progress the major industrial economies make in resolving current trade and fiscal imbalances. With the extent of the risks and uncertainties present in the international economy, it is all the more important that continued progress be made in improving the underlying structure of the Canadian economy. Tax reform will strengthen the economic fundamentals of the Canadian economy. This will help create both the fiscal and economic flexibility that may be needed in the years ahead.

3. Impacts on Provincial Government Revenues

The federal-provincial income tax collection agreements provide an arrangement whereby the federal government administers and collects provincial income taxes. All provinces except Quebec, which administers its own personal and corporate income taxes, have entered into agreements with the federal government. In the case of Ontario and Alberta the agreements cover personal income taxes only, since these provinces administer their own corporate income taxes.

Provinces participating in these arrangements have agreed to express their personal income tax rates generally as a percentage of basic federal tax. For the corporate income tax, the seven participating provinces apply their tax rate to corporate taxable income earned in a province as determined in the federal Income Tax Act and Regulations. Quebec, Ontario and Alberta have closely followed the federal definition of corporate taxable income used by the other provinces.

As a result of these federal-provincial linkages, the federal tax changes proposed under tax reform will automatically affect the calculation of provincial personal income tax payable for all provinces except Quebec. When the measures are fully effective by 1990, it is estimated that, in aggregate, provincial personal income tax revenues in provinces other than Quebec will be reduced by about $880 million. Were Quebec to provide reductions in personal income taxes equivalent to about 80 per cent of the reduction of basic federal tax on Quebec residents, total provincial personal income tax revenues would be reduced by about $1,275 million.

On the corporate income tax side, provinces generally share automatically in the revenues from broadening the tax base but are not affected by federal tax rate cuts. Assuming Ontario, Quebec and Alberta adopt the corporate income tax base-broadening measures, and provinces do not adjust their tax rates, corporate income tax revenues of all provinces would increase by about $885 million.

In addition to affecting provincial income tax revenues, tax reform will also have a direct impact on payments to provinces under certain federal transfer programs. The most significant impacts will be through the Established Programs Financing (EPF) arrangements, the contracting-out arrangements with Quebec and the

Fiscal Equalization program. Cash transfers to provinces under EPF and contracting-out will increase substantially. Equalization payments will also increase but the increases will be smaller.

Table 5.3

Direct Impact of Personal and Corporate Income Tax Reform on Provincial Government Revenues[1] 1990 Taxation Year

Revenue sources	Provinces other than Quebec	Quebec[2]	Total
		(millions of dollars)	
Personal income tax	−880	−395	−1,275
Corporate income tax	+815	+70	+885
EPF and Contracting-out cash	+210	+150	+360
Equalization	+15	+10	+25
Total	+160	−165	−5

[1] Calculations are based on the assumptions that all provinces other than Quebec maintain current personal income tax rates as percentage of basic federal tax, that all provinces maintain corporate rate of tax, and that Ontario, Quebec and Alberta, which operate their own corporate tax regimes, parallel federal base-broadening measures.

[2] Quebec administers its own personal income tax system which differs substantially from that of the federal and other provincial governments. Tax reform will not directly affect Quebec's income tax revenues. The calculations in this paper, however, take into account the impact on Quebec taxpayers and the revenues of the Government of Quebec that would occur if Quebec were to modify its tax system in response to federal changes proposed. Purely for the purpose of this analysis the assumption has been made that Quebec's personal income tax revenue reductions are equivalent to about 80 per cent of the reduction in basic federal tax in Quebec. This assumption is consistent with the assumptions used elsewhere in this paper that on average provincial income tax for all ten provinces represents 55 per cent of basic federal tax.

The estimated net impact on provincial revenues for the next five years is shown in Table 5.4. As the income tax reform measures become fully implemented, provincial revenues in aggregate will increase. To help offset the impact of tax reform on provinces in the first year, payments to provinces in respect of personal income tax will be accelerated. Table 5.4 takes into account this acceleration of personal income tax payments.

Table 5.4

Direct Impact of Personal and Corporate Income Tax Reform on Provincial Government Revenues, Taxation Years 1988 to 1992

	1988	1989	1990	1991	1992
	(millions of dollars)				
Newfoundland	–1	–8	–2	–	+2
Prince Edward Island	–	–2	+1	–	–
Nova Scotia	+1	–10	–1	+3	+5
New Brunswick	–	–10	–2	+2	+4
Ontario	+77	–18	+112	+180	+227
Manitoba	+7	–7	+5	+10	+14
Saskatchewan	+4	–7	+2	+10	+11
Alberta	+36	+8	+51	+68	+83
British Columbia	+1	–35	–6	+7	+18
Northwest Territories	+1	–1	–	–1	–
Yukon	–1	–	–	–1	–
Total excluding Quebec	+125	–90	+160	+278	+364
Quebec*	–186	–188	–165	–167	–155
Total	–61	–278	–5	+111	+209

* See footnote to Table 5.3.

6. Implementing Tax Reform

In this White Paper, the government has set out a comprehensive plan for the reform of Canada's tax system. The tax system is failing to meet the expectations and needs of Canadians. It is often unfair. It imposes obstacles to growth. It is an increasingly unstable source of government revenue. To resolve these problems is a major undertaking, involving substantial change. In the case of the sales tax, it will require the implementation of an entirely new tax system.

Tax reform will proceed in two stages.

The government intends to act expeditiously to implement the first stage of reform. In general these measures will become effective starting in the 1988 taxation year. To that end, the government intends to bring forward Ways and Means Motions to Parliament by the end of 1987. In the process of preparing these Motions, the government will consider the views of business, labour, representative associations, tax professionals and individual Canadians. The government will also invite the Standing Committee on Finance, Trade and Economic Affairs of the House of Commons to review these proposals. The work of the committee will provide an important opportunity for comment and discussion by Canadians.

In the second stage of tax reform, the government will implement a new sales tax system. The advantages of a National Sales Tax for economic efficiency, tax fairness and simplification warrant further examination. The provinces have expressed initial interest in a joint system. To explore this opportunity further, federal and provincial Finance Ministers will meet in the fall of this year to continue their work on sales tax reform.

Comprehensive sales tax reform, whether implemented on a national basis or at the federal level, will affect individual Canadians and groups, organizations and businesses across Canada. Their views on the implementation of the new sales tax are essential. Ongoing consultations between the Minister of Finance and representatives of business, labour and the non-profit sector will provide an important opportunity for discussion. As the preparatory work for implementing sales tax reform proceeds, officials of the Department of Finance will place a high priority on providing opportunities for consultation with interested groups and organizations. These discussions will help to clarify important technical issues regarding the application of the sales tax to individual sectors. The Standing Committee on Finance, Trade and Economic Affairs will also wish to examine the question of sales tax reform. Its hearings will provide a forum for public discussion.

Annex

Table of Cross References to Tax Reform Measures

This Annex lists the individual measures that are proposed in tax reform and cross-references them from this document to the related tax reform papers.

Reference key:	White Paper	WP
	Income Tax Reform	I
	Sales Tax Reform	S
	Economic and Fiscal Outlook	E
	Notice of Ways and Means Motion	W&M

Personal Income Tax

Corporate Income Tax

Income Tax Compliance and Administration

Transitional Measures

Sales Tax Reform

Economic and Fiscal Impacts of Tax Reform